Implementation Guide to Risk-based Audit of Financial Statements

(Revised Edition 2012)

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

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Foreword

The Institute is the regulator of the accountancy profession in India. As a part of its regulatory functions, it issues auditing standards which are performance benchmarks for the auditors. To enhance the global acceptability and competence of the Indian auditors, the auditing standards issued by the Institute are based on the International Standards issued by the International Auditing and Assurance Standards Board. It is essential that auditing standards issued by the Institute are properly understood and applied in true spirit by the members.

In the above context, it is therefore, necessary that the Institute, in addition to bringing out auditing standards, also develops guiding literature on those standards for the members. Implementation Guides to auditing standards are an important tool for the auditors to understand and implement the requirements of these standards in an appropriate manner to meet the objectives of these standards. The Implementation Guides also provide solutions to the practical problems being faced by the auditors in implementing these standards in the real life situations.

I am happy to note that the Auditing and Assurance Standards Board has brought out this Revised Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* whose first edition was issued in 2008. I am sure the Revised Implementation Guide would be able to address the apprehensions, concerns and difficulties, if any, being faced by the auditors regarding the risk based auditing standards.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives in bringing out guiding literature on auditing standards and other technical literature on auditing for the benefit of the members. I also eagerly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

May 2, 2012
New Delhi

CA. Jaydeep Narendra Shah
President, ICAI

Preface

The Institute, in the year 2007, had issued two Standards on Auditing, SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks". Both these Standards brought into focus the risk based approach to audit of financial statements.

In 2008, the Auditing and Assurance Standards Board brought out the 1st Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* with the objective of helping the members understand the requirements of above mentioned standards and make their implementation easier. The Implementation Guide also discussed the implications of SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 300, "Planning an Audit of Financial Statements" on carrying out risk based audits.

Since 2008, a number of new/revised Standards on Auditing have been issued by the Institute under the Clarity Project. Accordingly, the Auditing and Assurance Standards Board deemed it proper to revise the implementation guide. The Board is bringing out this thoroughly revised 2nd Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* for the benefit of the members. The Guide provides practical guidance on various aspects relating to risk-based audits in an easy and lucid language. It covers matters such as **Basic Concepts of Risk-based Audits** (for example, what is risk-based audit, audit risk components, interrelationship of audit risk components, risk-based approach etc.), **Risk Assessment** (for example, understanding the entity, internal controls, financial statement assertions, materiality and audit risk, risk assessment procedures, overall audit strategy, business risks, fraud risks, significant risks etc.) and **Risk Response** (for example, detailed audit plan, accounting estimates, related parties, subsequent events, going concern etc.). The Appendices to the Guide contain illustrations on overall audit strategy, understanding the entity, understanding the information system, risk assessment procedures, risk table, identification of risks, overall responses to the financial statements in general, etc.

I am extremely grateful to CA. Bhavani Balasubramanian, Chennai and her team comprising Ms. Sudha Prakash and Mr. Balajee Subramanian for squeezing time out of their pressing preoccupations for reviewing and revising the existing Guide and for preparing the draft of the Revised Guide.

At this juncture, I also wish to express my sincere thanks to, CA. Jaydeep N. Shah, President, ICAI as well as, CA. Subodh Kumar Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.*, CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, and Central Government nominee, Shri Gautam Guha and also to the co-opted members at the Board, *viz*., CA. Raj Agarwal, CA. Vinay Dattatray Balse, CA. Purshotam Gaggar, and CA. Pramod S. Shingte, for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz*., Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri S. Ravindran for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the draft its final shape.

I am sure that the members and other interested readers would find this Implementation Guide useful. I also eagerly look forward to the feedback of readers on the publication.

May 2, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

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Chapter 1
What is Risk-Based Audit

Overview

1.1 The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements. This involves the following three key steps:

- Assessing the risks of material misstatement in the financial statements;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an appropriate audit report based on the audit findings.

Reasonable Assurance

1.2 Reasonable assurance relates to the whole audit process. It is a high level of assurance but is not absolute. The auditor cannot provide absolute assurance due to the inherent limitations in the work carried out, the human judgments required, and the nature of evidence examined. The following Table outlines some of the limitations of an audit.

Limitations	Reasons
Use of Testing	Any sample of less than 100% of a population introduces some risk that a misstatement will not be detected.
Internal Control Limitations	Even the best designed and most effective controls can be

	overridden or negated by management or by collusion among employees.
Fraud that Goes Undetected	Because fraud is specifically designed to not be detected, there is always the possibility that it will not be discovered.
Nature of Audit Evidence Available	Most audit evidence tends to be persuasive in character rather than conclusive.
Availability of Audit Evidence	Insufficient support may be available for drawing absolute conclusions on specific assertions such as fair value estimates.
Reliance on Judgments Made by the Auditor	Professional judgment is required to: • Appropriately identify and address risk factors; • Decide what evidence to gather; • Assess estimates made by management; and • Draw conclusions based on the evidence and management representations.
Difficulty in Ensuring Completeness	There is a risk that some important information is not known about, not obtained or has been concealed from the auditor.

Audit Risk

1.3 Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The objective of the audit is to reduce this audit risk to an acceptably low level. The audit risk contains two key elements:

- The risk that the financial statements contain a material misstatement (inherent and control risk); and
- The risk that the auditor will not detect such a misstatement (detection or engagement risk).

To reduce audit risk to an acceptably low level, the auditor has to:

- Assess the risks of material misstatement; and
- Limit the detection risk.

  This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels.

Assertions

1.4 Included in management's representations about the financial statements are a number of embedded assertions. These relate to the recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.

However, for ease of use, this Guide has combined some of the assertions as follows:

- C = Completeness;
- E = Existence, which includes occurrence;
- A = Accuracy, which includes cut-off, classification and rights and obligations; and
- V = Valuation.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

"(a) Assertions about classes of transactions and events for the period under audit:

- *(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.*
- *(ii) Completeness—all transactions and events that should have been recorded have been recorded.*
- *(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.*
- *(iv) Cut-off—transactions and events have been recorded in the correct accounting period.*
- *(v) Classification—transactions and events have been recorded in the proper accounts.*

(b) Assertions about account balances at the period end:

- *(i) Existence—assets, liabilities, and equity interests exist.*
- *(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.*
- *(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.*
- *(iv) 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.*

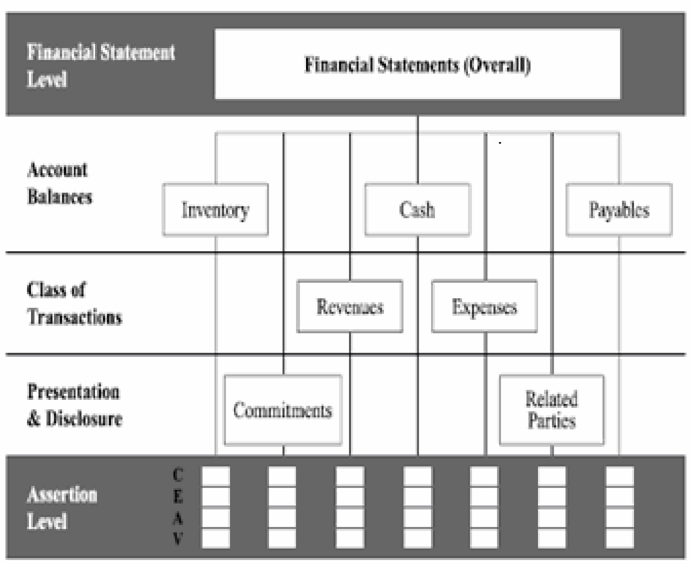
(c) Assertions about presentation and disclosure:

- *(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.*
- *(ii) Completeness—all disclosures that should have been included in the financial statements have been included.*
- *(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are*

clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts."

1.5 Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed. The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.



Note: The assertions used in this diagram are C = Completeness, E = Existence, A= Accuracy and cut-off, V = Valuation.

Audit Risk Components

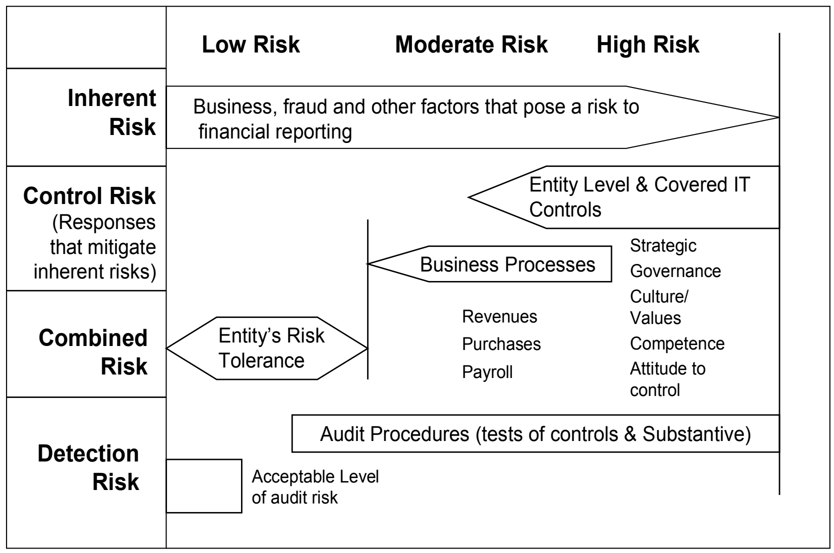
1.6 The major components of audit risk are described in the Table below.

Nature	*Description*	*Commentary*
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • A lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.

Fraud Risk (Part of inherent or possible control risk)	The risk of an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.	There are two types of intentional misstatement that are relevant to the auditor: • Misstatements resulting from fraudulent financial reporting; and • Misstatements resulting from misappropriation of assets.
Control Risk (Do internal controls in place mitigate the inherent risks?)	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally relate to specific assertions. Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.

Combined Risk	This is a term that is sometimes used to refer to the assessed (inherent and control risk) risks of material misstatement at both the financial statement level and the assertion level.	Auditors can make separate or combined assessments of inherent and control risks depending on preferred audit techniques or methodologies and practical considerations.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Interrelationship of Audit Risk Components



Risks of Material Misstatement

Notes:

1. The term "entity level controls" incorporates many elements of the control environment, risk assessment and monitoring components of internal control.

2. Many business risks can also be fraud risks. For example, a poorly controlled sales system may result in risks of misstatement and also provides opportunity for fraud to occur. For this reason, it is suggested that separate lists be maintained of business and fraud risk factors.

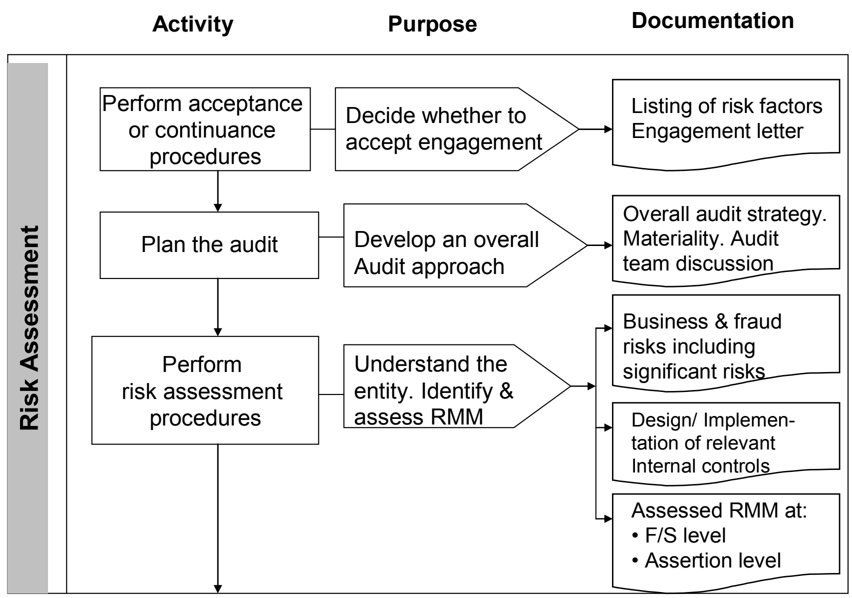
The Risk-based Approach

1.7 Throughout this Guide, the audit process is presented in three distinct phases:

- Risk assessment;
- Risk response; and
- Reporting.

The various tasks involved in each of these phases are outlined below. Each phase is addressed in more detail in subsequent chapters of this Guide.

Risk Assessment



1.8 Risk-based audits require practitioners to understand the entity and its environment, including internal control. The purpose is to identify and assess the risks of material misstatement of the financial statements. Because risk assessments require considerable professional judgment, this phase will likely require the time of the audit partner and senior audit personnel in identifying and assessing the various types of risk and then developing the appropriate audit response.

1.9 The risk assessment phase of the audit involves the following steps:

- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;

- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; an
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.

Parts of the risk assessment phase of the audit can often be carried out well before the year end.

1.10 The time involved in performing risk assessment procedures may be offset by reducing, or even eliminating, audit work in low risk areas. The knowledge and insight gained can also be used to provide the entity's management with practical comments and recommendations on how to minimize or reduce risk.

1.11 An effective risk assessment process requires that all members of the engagement team be involved and that they communicate effectively. The audit team[1] should meet or talk together on a regular basis to share their insights. This can be achieved through:

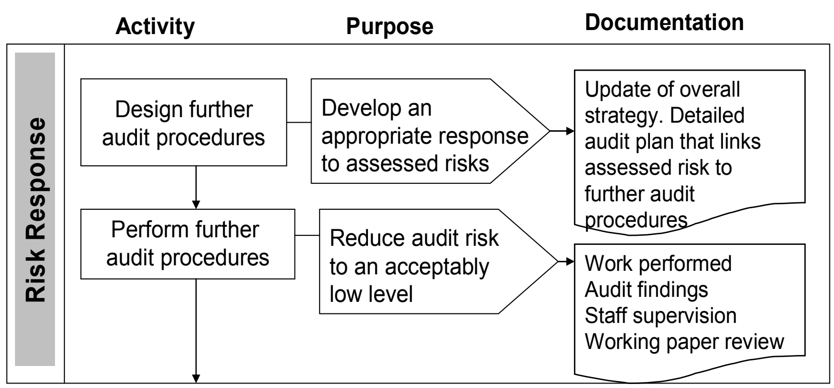
- A *team planning meeting* to discuss the overall audit strategy and detailed audit plan, brainstorm how fraud

[1] This Guide often refers to an audit team, which implies more than one person is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

could occur, and design audit procedures that may detect whether such fraud did in fact occur; and

- A *team debriefing meeting* (towards or at the end of the fieldwork) to discuss the implications of audit findings, identify any indications of fraud and determine the need, if any, to perform any further audit procedures.

Risk Response



1.12 The second phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.

1.13 Some of the matters the auditor should consider when planning the audit procedures include:

- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.

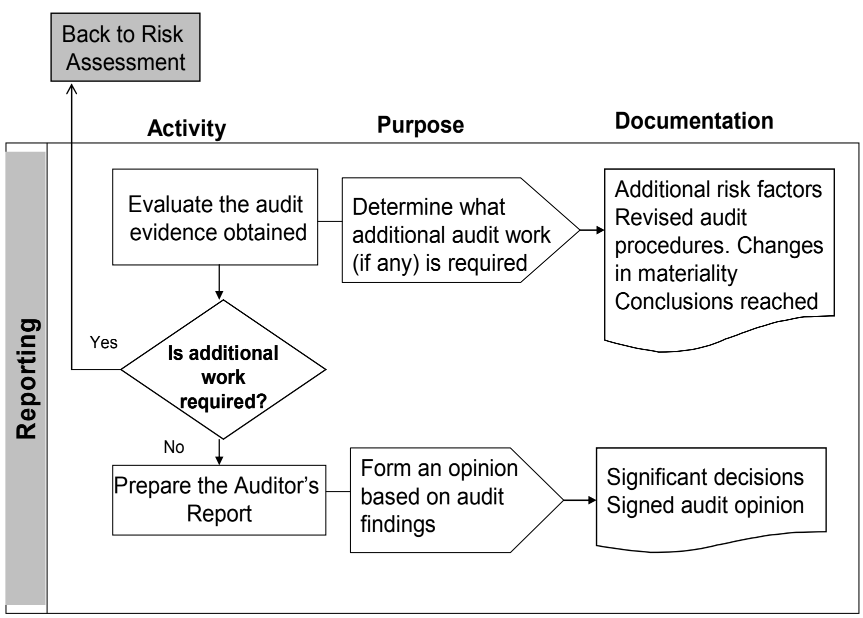
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address "significant risks" that have been identified.

1.14 Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures.

1.15 Refer Appendix 7 and Appendix 9 in this Guide for a template on Risk Table and Responses to the Risks Identified.

Reporting



1.16 The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risks of material misstatement in the financial statements to an acceptably low level. It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

1.17 Any additional risks should be appropriately assessed and further audit procedures performed as required.

When all procedures have been performed and conclusions reached:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed and a decision made on the appropriate wording for the auditor's report.

Summary

1.18 The risk-based audit requires auditors to first understand the entity and then to identify/assess the risks of material misstatement in the financial statements. This enables auditors to identify and respond to:

- Possible account balances, classes of transactions or financial statement disclosures that may be incomplete, inaccurately stated or altogether missing from the financial statements. Example:
    - Understated liabilities;
    - Unrecorded assets;
    - Assets such as cash/inventory that may have been misappropriated; and

   - Missing/incomplete disclosures.

- Areas of vulnerability where management override and manipulation of the financial statements could take place. Example:

   - Preparation of journal entries;
   - Revenue recognition policies; and
   - Management estimates.

- Other control weaknesses that, if not corrected, could lead to material misstatements in the financial statements.

1.19 Some of the benefits of this approach are summarised as follows:

- **Time flexibility for audit work**

  Risk assessment procedures can often be performed earlier in the entity's fiscal period than was possible before. Because risk assessment procedures do not involve the detailed testing of transactions and balances, they can be performed well before the year end, assuming no major operational changes are anticipated. This can help in balancing the workload of staff more evenly throughout the year. It may also provide the client with time to respond to identified (and communicated) weaknesses in internal control and other requests for assistance before the commencement of year-end audit fieldwork.

- **Audit team's effort focused on key areas**

  By understanding where the risks of material misstatement can occur in the financial statements, the auditor can direct the audit team's effort toward high-risk areas and away from lower-risk areas. This will also help to ensure audit staff resources are used effectively.

- **Audit procedures focused on specific risks**

  Further audit procedures are designed to respond to assessed risks. Consequently, tests of details that only address risks in general terms may be significantly reduced or even eliminated. The required understanding of internal control enables the auditor to make informed decisions on whether to test the operating effectiveness of internal control. Tests of controls (for which some controls may only require testing every three years) will often result in much less work being required than performing extensive tests of details.

- **Communication of matters of interest to management**

  The improved understanding of internal control may enable the auditor to identify weaknesses in internal control (such as in the control environment and general IT controls) that were not previously recognised. Communicating these weaknesses to management on a timely basis will enable them to take appropriate action, which is to their benefit. Also, this may in turn save time in performing the audit.

- **Improved audit file documentation**

  The SAs place a lot of emphasis on the need to carefully document each step of the audit process. Although this may add some additional cost at first, careful documentation will ensure that an audit file can stand by itself without the need for any oral explanations of what was done, why it was done, or how the audit conclusions were reached.

Part B
Risk Assessment

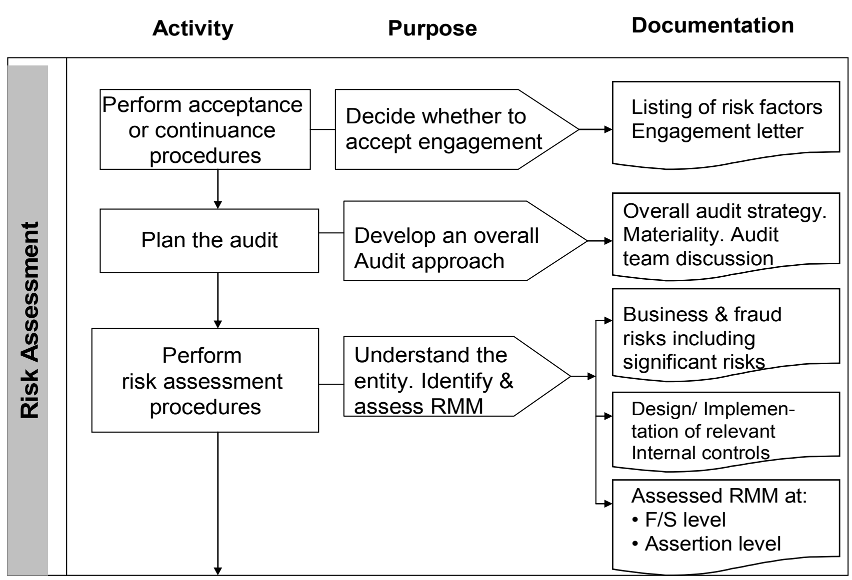
Chapter 2
Risk Assessment

Understanding the Entity

2.1 The purpose of this Section is to provide guidance on what is involved in understanding the entity and its environment necessary to:

- Identify and assess potential risk factors; and
- Sufficiently design and perform further audit procedures.

In this context SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" is the primary source of reference.



Overview

2.2 Paragraph 3 of SA 315 states:

"3. 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, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level."

2.3 Understanding the entity is an iterative process, continuing throughout the entire duration of the audit.

Paragraph 11 of SA 315 states:

"11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A21-A23)

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and

accounting policies used in the relevant industry. (Ref: Para. A24)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A25-A31)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A32-A37)."

2.4 Each year, the auditor's understanding of the entity should be updated and details of significant changes documented.

2.5 Financial statements provide a formal record of an entity's financial activities. Financial activities start with the entity's decision-making process, which will result from the business strategy, the control environment, and the business processes in place. As the decision-making process is implemented, business transactions take place which are recorded in the accounting records and summarised in financial statements. This is illustrated below.

2.6 Until the current risk-based Standards on Auditing (SAs) were issued, auditors would often gain a basic knowledge of the entity and then focus on obtaining sufficient audit evidence to support the content of the financial statements. Audit effort was primarily directed at the information about decisions made by management and the content of the financial statements.

2.7 The weakness of this approach was that the auditor may not be aware of, or fully comprehend, the significance of the information being recorded about decisions made by management. It is only by spending time to understand the nature of the business, the business strategy, its culture and values (control environment), the competence of the people, and the entity's structure and processes that it is possible to develop expectations about what types of information should, in fact, be recorded by the information system.

2.8 SAs require the auditor to take the time to properly understand the entity's decision-making processes. This includes the business strategy, the business and fraud risks factors, the culture, people and accountability relationships (control environment), and the internal controls established to address the risks. This foundation of understanding about the entity enables the auditor to:

- Identify business trends, risk factors, and key information that should be recorded in the entity's information system; and
- Plan more focused audit procedures (by responding to the specific risks identified) and thereby reduce the time being spent auditing certain financial statement balances.

2.9 Understanding the nature of the entity and its environment includes the following steps, as discussed in the corresponding Sections:

- What are Risk Assessment Procedures
- Business Risk
- Fraud Risk
- Significant Risks
- Internal Control
- Assessing Internal Control Design and Implementation
- Assessing the Risks of Material Misstatement

2.10 Understanding the nature of the entity and its environment, including internal control, provides the auditor with a frame of reference for making judgments about risk assessments and developing appropriate responses to risks of material misstatement in the financial statements.

2.11 This understanding assists the auditor in:

- Establishing materiality;
- Assessing management's selection and application of accounting policies;
- Considering the adequacy of financial statement disclosures;
- Identifying audit areas for special consideration (for example, related-party transactions, unusual or complex contractual arrangements, going-concern or unusual transactions);
- Developing expectations needed for performing analytical procedures;
- Designing/performing further audit procedures to reduce audit risk to an acceptably low level; and
- Evaluating sufficiency/appropriateness of audit evidence obtained (for example, Appropriateness of assumptions used and management's oral and written representations).

Consider Point

2.12 The information gained from risk assessment procedures conducted before engagement acceptance or continuance should be used as part of the audit team's understanding of the entity. It should be ensured that the information collected is readily available to the audit team after the engagement has been approved.

Sources of Information

2.13 Information about the entity and its environment can be obtained from both internal and external sources. In most cases, the auditor will start with the internal sources of information; however, these should be checked for consistency with information obtained from external sources. The following exhibit shows some of the potential sources of information available.

	Internal Sources		External Sources
Financial Information	• Financial statements • Budgets • Reports • Financial performance measures/metrics • Minutes • Income tax returns • Decisions made on accounting policies • Judgments and estimates		• Industry information • Competitive intelligence • Credit rating agencies • Creditors • Government Agencies • Franchisors • The media and other external parties
Non-financial Information	• Vision • Mission • Values • Objectives • Strategies • Organisation structure • Minutes • Job descriptions • Operating performance • Business drivers • Capabilities • Policy & procedure manuals • Non-financial performance measures/ metrics		• Trade association data • Industry forecasts • Government agency reports • Newspaper/ magazine articles • Information on the Internet

Consider Point

2.14 A major source of information is the auditor's own working paper files from previous years' engagements, if any, these often contain valuable information on matters such as:

- Considerations or issues to address in planning current year's audit;
- Evaluation and source of possible adjustments and uncorrected errors;

- Areas where there are recurring disagreements such as the assumptions used for accounting estimates;
- Areas which appear to be susceptible to error; and
- Matters raised in the auditor's communication with management and those charged with governance.

Scope of Understanding Required

2.15 In addition to the need to understand the relevant internal control, the auditor needs to understand and document four key areas, as outlined below.

1. External Factors	Nature of Industry Regulatory environment Financial reporting framework
2. Nature of Entity	Operations, ownership & governance People, investments & structure Application of accounting policies
3. Entity Objectives & Strategies	Related business risks Financial consequences
4. Measurement/ Review of Financial Performance	What key measures are used What pressures are on management to improve business performance

2.16 Additional information on each of the four areas is provided as follows.

External Factors

2.17 Matters to consider include:

- Industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments.
- The regulatory environment, including the applicable financial reporting framework.

- Specific risks arising from the nature of the business or the degree of regulation.
- The legal and political environment and environmental requirements affecting the industry and the entity.
- Laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.
- Other external factors, such as general economic conditions.

Nature of Entity

2.18 Matters to consider include:

- Entity's operations.
- Ownership and governance, including owners, family members, those charged with governance and relationships between owners and other people or entities.
- Types of investments (acquisitions, equipment, people, new products, locations, R&D, etc.) that the entity is making and plans to make.
- Entity structure (locations, subsidiaries, etc.) Complex structures may give rise to risks of material misstatement such as:
    - Allocation of goodwill and its impairment; and
    - Accounting for investments.
- How related party transactions are identified and accounted for.
- How the entity is financed.
- Whether the accounting policies appropriate for the business?
- Whether the accounting policies used in the relevant industry?

- Whether the accounting policies consistent with the applicable financial reporting framework?
- What methods are used to account for significant and unusual transactions?
- Whether there significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus? If so, consider the effect of using such policies.
- Whether there are any changes in the entity's accounting policies during the period? (This includes new financial reporting standards/regulations.) If so:
    - Document the reasons and consider appropriateness; and
    - Consider consistency with requirements of the applicable financial reporting framework.
- Whether there is adequate disclosure of material matters in the financial statements? Consider form, arrangement and content of the financial statements and footnotes, classification of items, amount of detail provided and basis of amounts set forth.

Entity Objectives and Strategies

2.19 Matters to consider include:

- Obtaining a copy of any mission, vision or values statement produced by the entity (such as in promotional or web-based materials) and consider its consistency with the entity's strategy and objectives. In smaller entities, this information will not often be documented but could possibly be obtained through discussions with management and observation of how they respond to such matters.

- Identifying and documenting the entity's strategies (that is, operational approaches by which management intends to achieve its objectives).
- Identifying and documenting the entity's current objectives (that is, its overall plans for the entity both short term and long term). In smaller entities, this information will likely be obtained through inquiry of management and observation of how they respond to such matters.
- Based on the understanding obtained about mission, vision, business strategies and objectives, identifying and documenting the related business risks.
- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies.

Measurement/ Review of Financial Performance

2.20 Matters to consider include:

- Identifying the key measures used by management to assess the entity's performance and achievement of objectives.
- Are there external parties that measure and review the entity's financial performance (regulators, franchisors, lending institutions, and so forth)? If so, consider whether copies of such reports should be obtained from the entity (for example, credit rating agency reports).
- Did the performance measures motivate management to take action to:
    - Improve the business performance?
    - Heighten risk by taking aggressive actions to achieve objectives?
    - Meet personal goals such as achieving a bonus threshold?

- Do the performance measures:
  - Highlight any unexpected results or trends?
  - Indicate trends or results consistent with the industry as a whole?
- Are the performance measures based on reliable information and precise enough to be used as a basis for analytical procedures?

2.21 Each industry tends to have its own key performance indicators (financial and non-financial) which the auditor should identify and consider first. Some typical key performance indicators include:

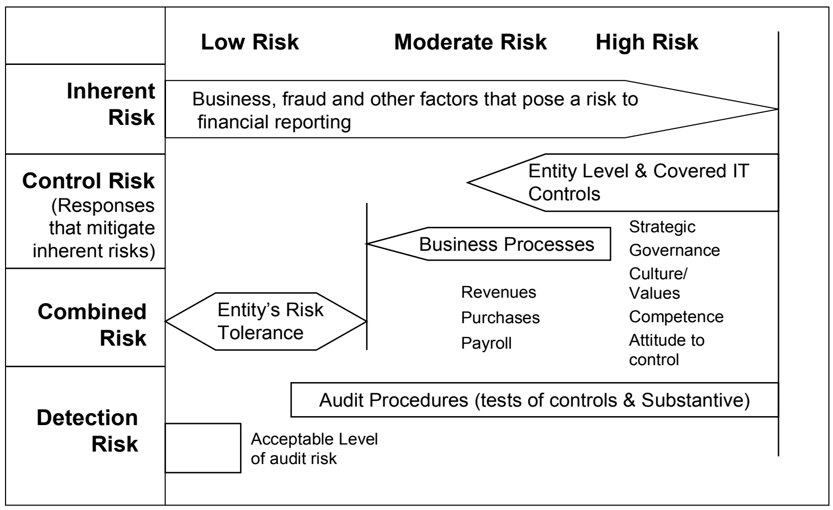
- Comparisons of performance to budgets;
- Variance analysis;
- Gross margin by product;
- Unit sales;
- Repeat contracts;
- New and lost customers;
- Segment information;
- Divisional, departmental or other level performance reports; and
- Comparison of the entity's performance with that of its competitors.

2.22 In smaller entities, management may rely on just one or two key indicators that may be reliable for evaluating financial performance and taking appropriate action.

2.23 The auditor should also consider information obtained from other sources, such as engagement acceptance and continuance procedures, that may be relevant to any of the four key areas that the auditor needs to understand and document.

Classifying the Information Obtained

2.24 The purpose of understanding the entity is to perform a risk assessment. This involves the identification and then the assessment of potential risks of material misstatement in the financial statements. The information obtained will consist of risk factors or sources of risk and the internal control system in place that will mitigate such risks, as illustrated in the exhibit below.



Risks of Material Misstatement

Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment, and monitoring components of internal control.

The sources of risk and the mitigation of risk can be further broken down as illustrated in the exhibit below.

Sources of Risk

Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment, and monitoring components of internal control.

2.25 The term "business risk" is broader than the risks of material misstatement in the financial statements. Business risk may also arise from change, complexity, or the failure to recognize the need for change. Change may arise, for example, from:

- The development of new products that may fail;
- An inadequate market, even if successfully developed; or
- Flaws that may result in liabilities and risk to reputation.

2.26 The auditor's understanding of the business risks increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for auditors to identify or assess all business risks.

2.27 The sufficiency of information (depth of understanding) required by the auditor is a matter of professional judgment. It is less than that possessed by management in managing the entity.

2.28 Subsequent sections in this Guide address the identification of business risk factors, fraud risk factors, internal control, and the combined risk assessment.

Documentation

2.29 The auditor should document key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Professional judgment should be used regarding the manner in which these matters are documented. The more complex the entity and the audit procedures required, the more extensive the documentation will be.

2.30 Documentation will, normally, include:

- Discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud and the significant decisions reached.

- Key elements of the understanding of the entity obtained regarding:
  - o Each of the aspects of the entity and its environment outlined above;
  - o Each of the internal control components;
  - o Sources of information from which the understanding was obtained; and
  - o The risk assessment procedures performed.
- The identified and assessed risks of material misstatement at the financial statement level and assertion level.
- Significant risks identified and evaluation of related controls.

2.31 In the documentation, it is important to obtain, in writing, management's acceptance of responsibility for the design and implementation of internal control. Refer Appendix 4 and Appendix 5 to the Guide for a template for understanding the entity and information systems.

Consider Point

2.32 It may not be necessary to prepare new documentation each year. The previous year's documents may be updated with changes and fresh information. But it should be ensured that changes can be identified as being made in the current audit period to document the fact that the information was updated.

Internal control

2.33 Internal control is designed and implemented by management to address identified business and fraud risks that threaten the achievement of stated objectives, such as the reliability of financial reporting. A control is always designed to respond (mitigate) to a possible risk. A control that does not address a risk is obviously redundant.

2.34 The first step in evaluating control design is to identify the risks that require mitigation by control. The second step is to identify what controls are in place to address those risks. This is often called the top-down approach to assessing control risk. The alternative is to first identify the controls in place and then match the controls to the risks that require mitigation.

Internal Control Objectives

2.35 Internal control is management's response to mitigate an identified risk factor or achieve a control objective. There is a direct relationship between an entity's objectives and the internal control it implements to ensure their achievement. Once objectives are set, it is possible to identify and assess potential events (risks) that would prevent the achievement of the objectives. Based on this information, management can develop appropriate responses, which will include the design of internal control.

2.36 Internal control objectives, and therefore the entity's internal control, can be broadly grouped into four categories:

- Strategic, high-level goals that support the mission of the entity;
- Financial reporting (internal control over financial reporting);
- Operations (operational controls); and
- Compliance with laws and regulations.

2.37 Internal control relevant to an audit primarily pertains to financial reporting. This addresses the entity's objective of preparing financial statements for external purposes.

2.38 Operational controls, such as production and staff scheduling, quality control and employee compliance with health and safety requirements, would not normally be relevant to the audit, except where:

- The information produced is used to develop an analytical procedure; or
- The information is required for disclosure in the financial statements.

For example, if production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant. If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance would be relevant.

Internal Control Components

2.39 The term "internal control" is much broader than some of the traditional definitions of internal control that focused narrowly on control activities, such as segregation of duties, authorizations and account reconciliations, etc. Internal control encompasses five key components:

- The 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 internal control.

2.40 These components as they relate to the entity's financial reporting objectives are illustrated below.

The division of internal control into these five components provides a useful framework for auditors in understanding the different aspects of an entity's internal control system. However, it should be noted that:

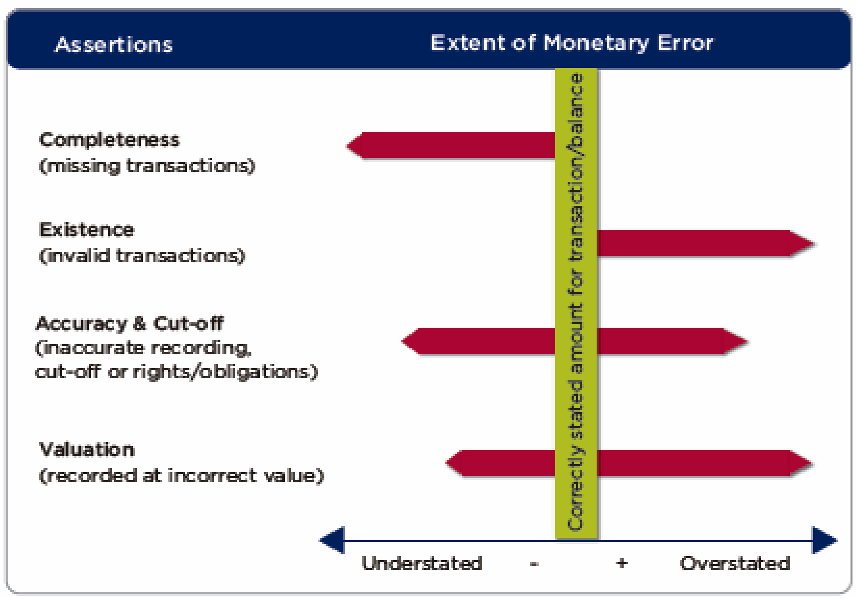
- The way in which the internal control system is designed and implemented will vary based on the entity's size and complexity. Smaller entities often use less formal means and simpler processes and procedures to achieve their objectives. The five components of internal control may not be so clearly distinguished; however, their underlying purposes are equally valid. For example, an owner-manager may (and, in the absence of additional staff, should) perform functions belonging to several of the components of internal control.

- Different terminology or frameworks can be used to describe the various aspects of internal control and their effect on the audit, but all five components are to be addressed in the audit.

- The auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances or disclosures and their related assertions, rather than its classification into any particular internal control component.

A summary of the five internal control components is provided in the sections that follow.

Financial Statement Assertions



2.41 Representations by management, such as that the financial statements as a whole are presented fairly in accordance with the applicable financial reporting framework, contain a number of embedded assertions. These assertions relate to the recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements. Examples of management's assertions include:

- All the assets in the financial statements exist;
- All sales transactions have been recorded in the appropriate period;
- Inventories are stated at appropriate values;
- Payables represent proper obligations of the entity;
- All recorded transactions occurred in the period under review; and

- All amounts are properly presented and disclosed in the financial statements.

2.42 These assertions are often summarized by appropriate terms such as completeness, existence, occurrence, accuracy, valuation, etc. For example, management may assert to the auditor that the sales balance in the accounting records contains all the sales transactions (completeness assertion), the transactions took place and are valid (occurrence assertion), and transactions have been properly recorded in the accounting records and in the appropriate accounting period (accuracy and cut-off assertion).

Description of Assertions

2.43 The categories of assertions that can be used by the auditor to consider the different types of potential misstatements are described below.

	Assertion	**Description**
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.
	Cut-off	Transactions and events have been recorded in the correct accounting period.
	Classification	Transactions and events have been recorded in the proper accounts.

	Assertion	Description
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	All assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

	Assertion	Description
Presentation and Disclosure	Occurrence, 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 is disclosed fairly and at appropriate amounts.

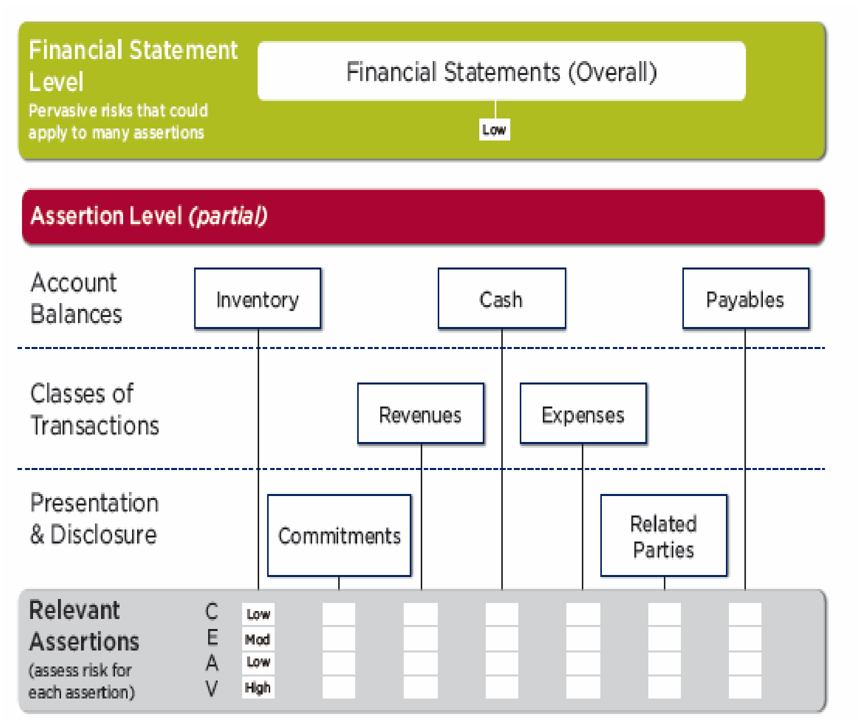
Using Assertions in Auditing

2.44 As previously stated, the financial statements contain a number of embedded assertions. Assertions can be used by the auditor in assessing risks at the financial statement level and the assertion level.

Assessing Risks at	Commentary
Financial Statement Level	The risks of material misstatement at the financial statement level tend to be pervasive and therefore address all the assertions. For example, if the top accountant is not competent enough for the assigned tasks, it is quite possible that errors could occur in the financial statements. However, the nature of such errors will not often be confined to a single account balance, transaction stream or disclosure. In addition, the error will not likely be confined to a single assertion such as the completeness of sales. It could just as easily relate to other assertions such as accuracy, existence and valuation.
Assertion Level	Risks at the assertion level relate to individual account balances at a point in time (i.e., the period end), classes of transactions (for the fiscal period) and presentation and disclosure in the financial statements. Pervasive risks that address all assertions are assessed at the financial statement level. The relevance of each assertion to an individual account balance (or class of transactions or presentation and disclosure) will vary based on the characteristics of the balance and the potential risks of material misstatement. For example, when considering the valuation assertion, the auditor could assess the risk of error in payables as low; however, for inventory where obsolescence is a factor, the auditor would assess the valuation risk as high.

	Another example would be where the risks of material misstatement due to completeness (missing items) in the inventory balance are low, but high in relation to the sales balance.

2.45 The difference between the two levels of risk assessment is illustrated in partial form in the exhibit below.



2.46 Assertions are used by the auditor to form a basis for:

- Considering the different types of potential misstatements that may occur;
- Assessing the risks of material misstatement; and
- Designing further audit procedures that are responsive to the assessed risks.

Use of Assertions	Procedures
Considering Types of Potential Misstatement	This would include performing risk assessment procedures to identify possible risks of material misstatement. For example, the auditor might ask questions such as the following: • Does the asset exist? (Existence) • Does the entity own it? (Rights obligations) • Are all the sales transactions properly recorded? (Completeness) • Has the inventory balance been adjusted for slow-moving and obsolete items? (Valuation) • Does the payable balance include all known liabilities at the period end? (Completeness) • Were transactions recorded in the right period? (Cut-off) • Are amounts properly presented and disclosed in the financial statements? (Accuracy)
Assessing Risks of Material Misstatement	The risk of material misstatement is a combination of inherent risk and control risk. The assessment process

	includes: • Inherent risk Identify potential misstatements and the assertions involved and then assess the likelihood of the risk's occurrence and possible magnitude. • Control risk Identify and evaluate any relevant internal controls in place that mitigate the assessed risks and address the underlying assertions.
Designing Audit Procedures	The final step is to design audit procedures to be responsive to the assessed risks by assertion. For example, if the risk is high that receivables are overstated (existence assertion), the audit procedures should be designed to specifically address the existence assertion. If sales completeness was a risk, the auditor could design a test of controls that addresses the completeness assertion.

Materiality and Audit Risk

2.47 Materiality addresses the significance of financial statement information to economic decisions taken by users on the basis of the financial statements. The determination of materiality by an auditor is a matter of professional judgment.

2.48 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important to people making an economic decision based on the financial statements. This could include decisions such as whether to invest in, purchase, do business with, or lend money to an entity.

2.49 When a misstatement (or the aggregate of all misstatements) is significant enough to change or influence the decision of an informed person, a material misstatement has occurred. Below this threshold, the misstatement is generally regarded as not material. For example, if it is determined that the decision of a financial statement user group would be influenced by a misstatement of Rs. 10,000 in the financial statements, the auditor would need to plan and perform procedures to detect any misstatements of that amount or in excess of that amount.

2.50 Materiality is often explained (such as in financial reporting frameworks) in the terms set out below.

Influence on Making Economic Decisions

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

Surrounding Circumstances

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

Common Needs of Users

2.53 Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

2.54 The auditor determines materiality based on his/her perception of the needs of users. In applying his/her professional judgment, it is reasonable for the auditor to assume that users of the financial statements:

- Have a reasonable knowledge of business, economic activities, and accounting and have a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.
- Misstatements may arise from a number of causes and can be based on the following.
- Size — the monetary amount involved (quantitative);
- Nature of the item (qualitative); and
- Circumstances surrounding the occurrence.

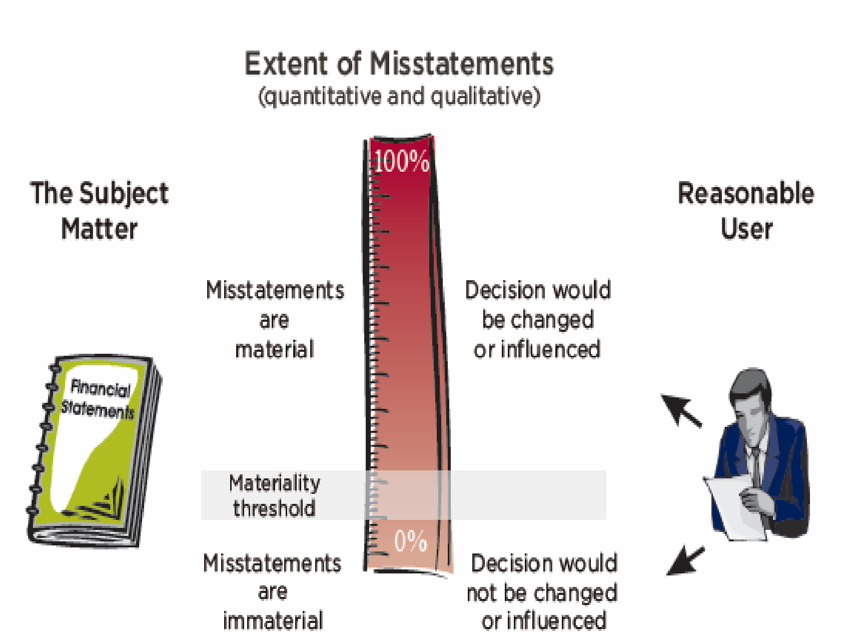
Typical Misstatements

- Errors and fraud identified in the preparation of the financial statements;
- Departures from the applicable financial reporting framework;
- Employee and management fraud;
- Management error;
- Preparation of inaccurate or inappropriate estimates; or
- Inappropriate or incomplete descriptions of accounting policies or note disclosures.

2.55 Materiality is not an absolute number. It represents a grey area between what is very likely not material and what is very likely material. Consequently, the assessment of what is material is always a matter of professional judgment.

2.56 In some situations, a matter well below the quantitative materiality level may be determined as material based on the nature of the item or the circumstances related to the misstatement. For example, the information that there are a number of transactions with related parties may be very significant to a person making a decision based on the financial statements.

2.57 Finally, a series of immaterial items may well become material when aggregated.



Materiality and Audit Risk

2.58 Materiality (as discussed above) and audit risk are related and are considered together throughout the audit process. Audit risk is the possibility that an auditor expresses an inappropriate audit opinion on financial statements that are materially misstated.

Audit Risk Components

Risks of Material Misstatement (RMM)	The risk that the financial statements are materially misstated prior to the start of any audit work. These risks are considered at the financial statement level (often pervasive risks, affecting many assertions) and at the assertion level, which relates to classes of transactions, account balances, and disclosures. RMM is a combination of inherent risk (IR) and control risk (CR), which can be summarized as IR x CR = RMM
Detection Risk	The risk that the auditor fails to detect a misstatement that exists in an assertion that could be material. Detection risk (DR) is addressed through: • Sound audit planning; • Performing audit procedures that respond to the risks of material misstatement identified; • Proper assignment of audit personnel; • The application of professional skepticism; and • Supervision and review of the audit work performed.

2.59 Detection risk can never be reduced to zero. This is because of the inherent limitations in the audit procedures carried out, the human (professional) judgments required and the nature of the evidence examined.

Audit risk (AR) can therefore be summarized as:

AR = RMM x DR

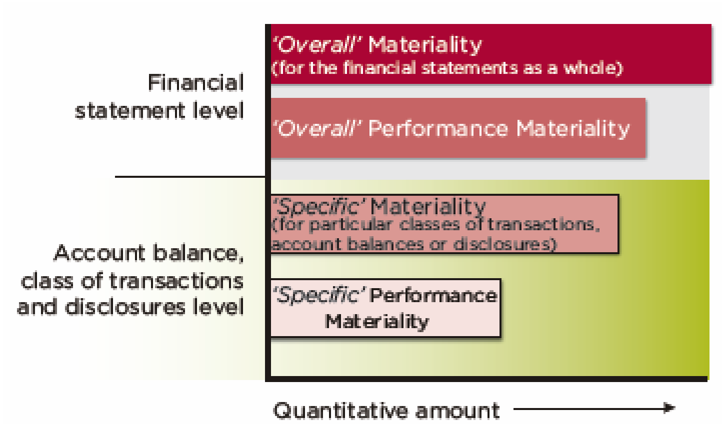
2.60 Materiality and audit risk are considered throughout the audit in:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

2.61 Using a simple analogy of a high jump in athletics, materiality would be equivalent to the height of the bar that the athlete has to jump over. Audit risk is equivalent to the level of difficulty inherent in the jump at that particular height (RMM) combined with the additional risk of making a mistake in jump strategy or execution (detection risk).

Materiality Levels

2.62 For purposes of the SAs, Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, 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.



Note: Overall materiality refers to the financial statements as a whole and specific materiality relates to materiality of particular classes of transactions, account balances or disclosures.

2.63 At the start of the audit, the auditor makes judgments about the size and nature of misstatements that would be considered material. This includes establishing materiality amounts as set out below.

Establishing Materiality Amounts

Overall Materiality (for the financial statements as a whole)

2.64 Overall materiality relates to the financial statements as a whole. It is based on the extent of error of what could reasonably be expected to influence the economic decisions of the financial statement users, taken on the basis of the financial statements. It would not be changed as a result of audit findings.

Overall Performance Materiality

2.65 Performance materiality is set at a lower amount than the overall materiality. Performance materiality enables the auditor to respond to specific risk assessments (without changing the overall materiality) and to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount. Performance materiality would be changed based on audit findings (such as where a risk assessment was revised).

Specific Materiality

2.66 Specific materiality is established for classes of transactions, account balances or disclosures where misstatements of lesser amounts than overall materiality could reasonably be expected to influence the economic decisions of users, taken on the basis of the financial statements.

Specific Performance Materiality

2.67 Specific performance materiality is set at a lower amount than the specific materiality. This enables the auditor to respond to specific risk assessments and to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

Overall Materiality

2.68 Overall materiality level (for the financial statements as a whole) is based on the auditor's perception of the financial information needs of users of the financial statements. Using professional judgment, the auditor would set materiality at the highest amount of misstatement that would not influence the economic decisions of financial statement users.

2.69 Once established, the overall materiality amount becomes the standard by which the ultimate success or failure of the audit will be judged. For example, assume overall materiality was set at an amount of Rs. 20,000. If as a result of performing audit procedures:

- No errors were found — an unqualified opinion would be provided.
- Uncorrected errors exceeding materiality (of Rs. 20,000) were found and the client was unwilling to make the necessary adjustments — a qualified or adverse opinion would be required.
- Uncorrected errors exceeding materiality (of Rs. 20,000) exist in the financial statements but were not detected by

the auditor — an inappropriate unqualified audit opinion may be issued.

2.70 Auditors are sometimes tempted to lower the overall materiality amount when the risk of material misstatement is assessed as high. This would not be appropriate, however, as overall materiality addresses the needs of financial statements users, not the level of audit risk involved.

2.71 If audit risk was a factor in setting overall materiality, a high-risk audit would end up with a lower overall materiality amount than that set for a similar-sized entity where audit risk was low.

2.72 Assuming that the information needs of financial statement users are the same, regardless of audit risk, setting the overall materiality amount at a lower level would result in:

- Providing financial statement users with an expectation that smaller misstatements in the financial statements (than is actually necessary) will be identified by the auditor; and
- Additional audit work to ensure the risk of material misstatement (defined as errors and fraud in excess of the amount set for overall materiality) has been reduced to an appropriately low level.

Because overall materiality is set in relation to the needs of financial statement users, it would not be changed as a result of the audit findings and changes in assessed risks. Overall materiality would only be updated for a change in the perceived needs of financial statements users.

2.73 At the conclusion of the audit, overall materiality will be used for evaluating the effect of identified misstatements on the financial statements and the appropriateness of the opinion in the auditor's report.

Performance Materiality

2.74 Performance materiality allows the auditor to address the risks of misstatement in account balances, classes of transactions and disclosures without having to change the overall materiality. Performance materiality enables the auditor to establish materiality amounts that are lower than overall materiality to reflect the risk assessments. This lower amount establishes a safety buffer between the materiality used for determining the nature and extent of testing (performance materiality) and the materiality amount for the financial statements as a whole (overall materiality).

2.75 Setting an appropriate amount for performance materiality will ensure that more work is performed, which increases the likelihood that misstatements (if they exist) will be identified.

For example, if overall materiality was Rs. 20,000 and audit procedures were planned to detect all errors in excess of Rs. 20,000, it is quite possible that an error of say Rs. 8,000 would go undetected. If three such errors existed, amounting to Rs. 24,000, the financial statements would be materially misstated. However, if performance materiality was set at Rs. 12,000, it would be much more likely that at least one or all of the Rs. 8,000 errors would be detected. Even if only one of the three errors was identified and corrected, the remaining misstatement of Rs. 16,000 would be less than the overall materiality and the financial statements as a whole would not be materially misstated.

2.76 Setting an appropriate amount for performance materiality involves the exercise of professional judgment and is not a simple mechanical calculation such as a percentage (for example, 75%) of the overall materiality level. However, based on the particular circumstances of the entity being audited, it could be set as a single amount for the financial statements as a whole, or at individual amounts for particular balances, transactions and disclosures.

2.77 The determination of performance materiality involves the exercise of professional judgment based on factors that address audit risk such as the following:

- Understanding of the entity and results of performing risk assessment procedures;
- Nature and extent of misstatements identified in previous audits; and,
- Expectations of possible misstatements in the current period.

2.78 Performance materiality as a whole or for individual balances, transactions and disclosures can be changed at any time during the audit (without impacting overall materiality) to reflect revised risk assessments, audit findings and new information obtained.

2.79 At the conclusion of the audit, the overall materiality would be used for evaluating the effect of identified misstatements on the financial statements and determining the opinion to be expressed in the auditor's report.

Specific Materiality

2.80 There are some situations where misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, taken on the basis of the financial statements.

Decision Influencers	Possible Examples
Laws, Regulations and Requirements of the Financial Reporting Framework	• Sensitive financial statement disclosures such as the remuneration of management and those charged with governance. • Related-party transactions. • Non-compliance with loan covenants, contractual agreements, regulatory provisions and statutory /

	regulatory reporting requirements. • Certain types of expenditures such as illegal payments or executives' expenses.
Key Industry Disclosures	• Reserves and exploration costs for a mining entity. • Research and development costs for a pharmaceutical entity.
Disclosure of Significant Events and Important Changes in Operations	• Newly acquired businesses or expansion of operations. • Discontinued operations. • Unusual events or contingencies (e.g., lawsuits). • Introduction of new products and services.

2.81 The auditor would consider the existence of matters such as the above for one or more particular classes of transactions, account balances or disclosures. The auditor may also find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

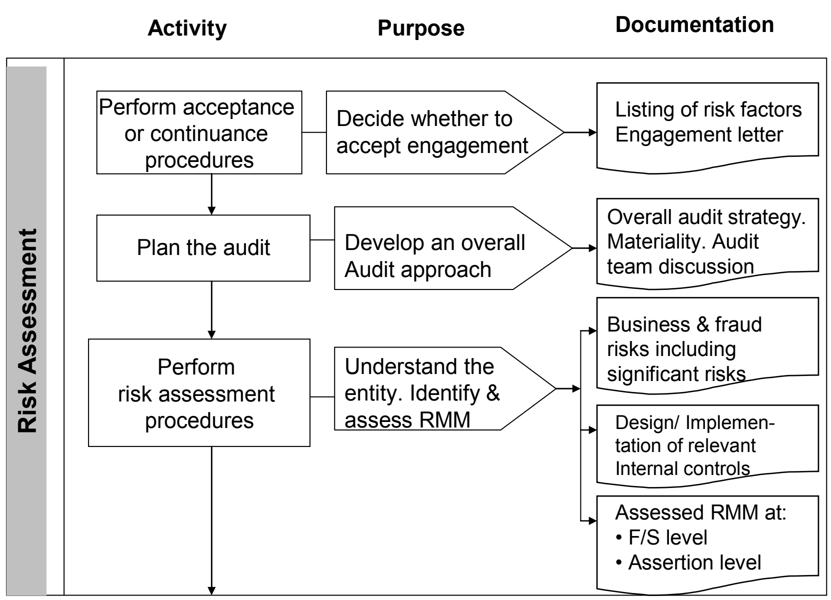
2.82 Once a specific materiality amount has been determined a specific performance materiality may be set. This would be a smaller amount than the specific materiality to ensure sufficient audit work is performed to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

Documentation of Materiality

2.83 Because materiality amounts are based on the auditor's professional judgment, it is important that the factors and amounts involved in determining materiality at the various levels be properly documented. This would typically occur during the planning phase and then later in the audit should revisions be required. Documentation would address:

- The users of the financial statements;
- Determination of overall materiality relating to the financial statements as a whole;
- Performance materiality indicating any specific considerations relating to particular classes of transactions, account balances or disclosures and any revisions made to performance materiality during the audit; and
- Nature of revisions (if any) made to the overall or performance materiality amounts.

Risk Assessment Procedures



2.84 The purpose of this Section is to explain the purpose and nature of risk assessment procedures and how they relate to the development of the detailed audit plan and overall audit strategy.

In this context SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" is the primary source of reference.

Overview

2.85 Paragraph 6 of SA 315 states:

"6. The risk assessment procedures shall include the following:

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)

(b) Analytical procedures. (Ref: Para. A7-A8)

(c) Observation and inspection. (Ref: Para. A9)"

2.86 Paragraph 9 of SA 315 states:

"9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A10-A11)"

2.87 The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit.

2.88 Risk assessment procedures are designed for obtaining an understanding of the entity and its environment, including its internal control. This understanding should be a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit.

Nature of Evidence Obtained

2.89 Risk assessment procedures provide the audit evidence necessary to support the assessment of risks at the financial statement and assertion levels. However, this evidence does not stand alone. At the risk response phase of the audit, the evidence obtained will be supplemented by further audit procedures (that respond to the risks identified) such as tests of controls and/or substantive procedures.

Where efficient, further procedures such as substantive procedures or tests of controls may be performed concurrently with the risk assessment procedures.

Required Procedures

2.90 There are three risk assessment procedures, as illustrated below.

Each of these procedures should be performed during the audit, but not necessarily for each aspect of the understanding required. In many situations, the results from performing one type of procedure may lead to another. For example, the findings from analytical procedures on preliminary operating results may trigger inquiries of management. The answers to the inquiries may then lead to requests to inspect certain documents or observe some activities.

The nature of the three procedures is outlined below.

Inquiries of Management and Others

2.91 The goal of this procedure is to understand the entity and to identify/assess the various sources of risk that exist. Some areas of inquiry would include those outlined in the following table.

Inquire To	Inquire About
Management and Those Responsible for Financial Reporting / Those Charged with Governance	• The processes in place for identifying and responding to the risks of fraud and error in the financial statements. • How management communicates, if at all, to employees regarding its views on business practices, adherence to policies and procedures, and ethical behavior. • The role they play. • The entity's culture (values and ethics). • Management's operating style. • Management incentive plans. • Potential for management override. • Knowledge of fraud or suspected fraud. • The financial statement preparation and review process. Also consider attending a meeting of those charged with governance and reading the minutes of their meetings.
Key Employees (Purchasing, payroll, accounting, etc.)	• The initiating, processing or recording of complex or unusual transactions. • The extent of management override (have they ever been asked to override internal controls). • The appropriateness/application of the accounting policies used.

Marketing or Sales Personnel	• Marketing strategies and sales trends. • Sales performance incentives. • Contractual arrangements with customers. • The extent of management override (have they ever been asked to override internal controls or revenue recognition accounting policies?).

Consider Point

2.92 The questions, especially in smaller audits, should not be confined to the owner-manager and the accountant. Others in the entity (such as the sales manager, production manager or other employees) may also be inquired about trends, unusual events, major business risks, the functioning of internal control, and any instances of management override.

Analytical Procedures

2.93 Analytical procedures used as risk assessment procedures help to identify matters that have financial statement and audit implications. Some examples are unusual transactions or events, amounts, ratios, and trends.

2.94 There are two other major purposes for using analytical procedures:

- As the primary source of evidence for a financial statement assertion. This would be a substantive analytical procedure; and
- In performing an overall review of the financial statements at, or near, the end of the audit.

2.95 Most analytical procedures are not very detailed or complex. They often use data aggregated at a high level, which means the results can only provide a broad initial indication about whether a material misstatement may exist.

2.96 The steps involved in performing analytical procedures are outlined below.

What to do	How to do it
Identifying Relationships Within the Data	Develop expectations about plausible relationships among the various types of information that could reasonably be expected to exist. Seek to use independent sources of information (that is, not internally generated) where possible. The financial and non-financial information could include: • Financial statements for comparable previous periods; • Budgets, forecasts, and extrapolations, including extrapolations from interim or annual data; and • Information regarding the industry in which the entity operates and current economic conditions.
Comparing	Compare expectations with recorded amounts or ratios developed from recorded amounts.
Evaluating Results	Evaluate the results.

	Where unusual or unexpected relationships are found, consider potential risks of material misstatement.

2.97 The results of these analytical procedures should be considered along with other information gathered to:

- Identify the risks of material misstatement related to assertions embodied in significant financial statement items; and
- Assist in designing the nature, timing and extent of other auditing procedures.

Observation and Inspection

2.98 Observation and inspection support the inquiries made of management and others and provide information about the entity and its environment.

2.99 Observation and inspection procedures ordinarily include a procedure and its application, as outlined below.

Procedure	Application
Observation	• How the entity operates and is organized; • Management's operating style and attitude toward internal control; • Operation of various internal control procedures; and • Compliance with certain policies.
Inspection	• Business plans and strategies;

	• Accounting policies and records; • Internal control manuals; • Reports prepared by management (such as interim financial statements); and • Other reports such as minutes from meetings of those charged with governance, reports from consultants, etc..

Other Risk Assessment Procedures

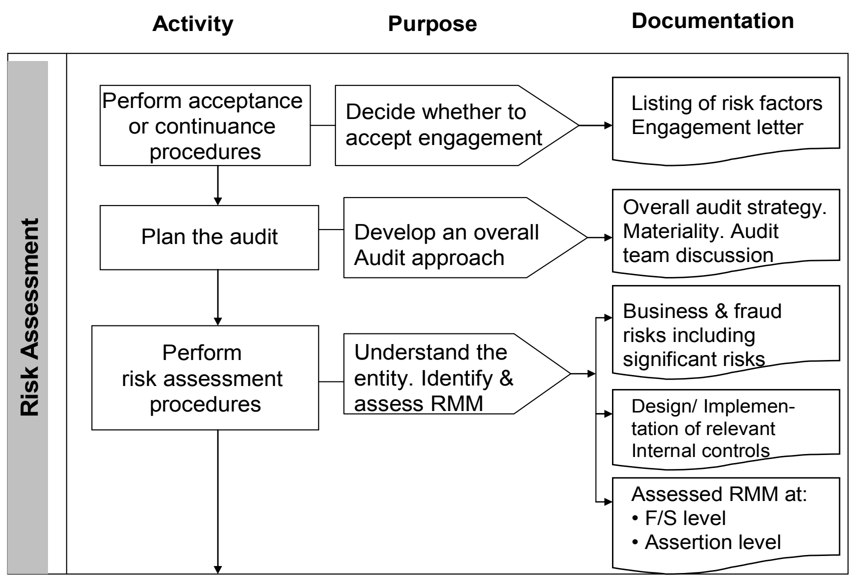
2.100 Other procedures not listed above may also be used for risk assessment purposes. Examples include:

- Information obtained from pre-engagement procedures;
- Experience gained from previous engagements and other engagements performed for the entity;
- Information about the entity and its environment obtained in prior periods such as:
  - o Organizational structure, business processes, and internal control,
  - o Past misstatements and whether they were corrected on a timely basis, and
  - o Before such information can be used, the auditor should first determine (through inquiries, walkthroughs, etc.) whether changes have occurred that may affect its relevance to the current audit;
- Inquiries of the entity's external legal counsel or of valuation experts;

- Reviewing information obtained from external sources such as reports by banks or rating agencies, trade and economic journals, and regulatory and financial publications;
- Evidence obtained from evaluating the design of internal control and determining whether the control procedures have been implemented; and
- Results of discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatements.

Refer Appendix 6 and Appendix 8 to the Guide for a template on risk assessment procedures and risk identification.

Overall Audit Strategy



2.101 The purpose of this Section is to describe the steps involved in developing the overall audit plan, including the overall audit strategy to address the identified risks of material misstatement. In this context, SA 300, "Planning an Audit of Financial Statements" is the primary source of reference.

Overview

2.102 SA 300 states:

“3. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Planning is important to ensure that the engagement is performed in an efficient and effective manner and that audit risk has been reduced to an acceptably low level.

Audit planning is not a discrete phase of the audit. It is a continual and iterative process that starts shortly after completion of the previous audit and continues until the completion of the current audit.

6. 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.

8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 “The Auditor’s Responses to Assessed Risks”.

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.”

2.103 There are two levels of planning for the audit as illustrated in the exhibit below.

2.104 The overall strategy begins during the risk assessment phase of the audit. The detailed audit plan can begin when there is sufficient information about assessed risks to develop an appropriate audit response. This will most often take place at the risk response phase of the audit.

2.105 The nature and extent of planning activities will vary according to several factors:

- The size and complexity of the entity;
- The composition and size of the audit team. Smaller audits will also have smaller teams, making planning, coordination, and communication easier;
- The auditor's previous experience with the entity; and
- Changes in circumstances that occur during the audit engagement.

2.106 The benefits of audit planning are outlined in the table below.

Benefits of Audit Planning	• Team members learn from the experience/insight of the partner and other key personnel. • The engagement is properly organized, staffed, and managed. • Experience gained from previous years' engagements and other assignments is properly utilized. • Important areas of the audit receive the appropriate attention. • Potential problems are identified and resolved on a timely basis. • Audit file documentation is reviewed on a timely basis. • Work performed by others is coordinated (other auditors, experts, etc.).

Developing the Overall Audit Strategy

2.107 As mentioned, 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.

2.108 The first step in planning is to gather information about the entity and determine the nature and extent of the required risk assessment procedures, and who will perform them. It also includes the scheduling of the audit team meeting to discuss the susceptibility of the entity to material misstatements (including fraud) in the financial statements. Then, as risks are identified and assessed, the appropriate audit response can be developed which will involve determining the nature, extent, and timing of the further audit procedures required. Other considerations involved in planning could involve the determination of materiality, involvement of experts, and any additional risk assessment procedures that may be required.

2.109 When the risks of material misstatement have been identified and assessed, the overall strategy (including timing, staffing, and supervision) can be finalized, and a detailed audit plan developed. The detailed plan will set out the further audit procedures required at the assertion level that will be responsive to the identified risks.

2.110 As work commences, changes may be required to the overall and detailed plans to respond to new circumstances, audit findings, and other information obtained.

Refer Appendix 3 to the Guide for a template of determining the Overall Audit Strategy.

Consider Point

Small entity audits are often conducted by very small audit teams. This makes coordination and communication among the team easier and the overall audit strategy can be straightforward. Documentation for small entities may be in the form of a brief memorandum that includes:

- Nature of engagement and timing;
- Issues identified in the audit just completed;
- What has changed in the current period;
- Any revisions required in the overall audit strategy or in the detailed audit plan; and
- The specific responsibilities of each member of the audit team.

Planning for the current year can start with a brief memo prepared at the end of the previous audit. This memo can be used as the basis for planning the current period when it has been changed and updated for the current period, based on discussions with the owner-manager.

Learn from the Prior Year's Experience

2.111 Once the previous audit is complete, it is useful to obtain feedback from the audit team on what could be improved. This would include identifying:

- Any audit areas that might require additional or less attention in the future;
- Any planned changes that will affect future engagements such as an acquisition, new product or service, or the installation of a new accounting system; and
- Where additional assistance could be provided by the entity such as analysis of certain accounts.

Consideration in Planning

2.112 Planning is a critical step in performing an efficient and effective engagement. Time spent in planning can focus work effort toward material matters and away from insignificant matters. Planning helps to:

- Focus partner / staff attention on the engagement objectives;
- Identify the critical issues to be addressed and develop an appropriate response;
- Ensure that a coherent set of audit procedures are developed to achieve the engagement objectives. This also includes the removal of audit procedures considered unnecessary (based on the practitioner's judgment); and
- Identify ways in which the entity could assist the engagement, such as preparing certain working papers and analysis.

2.113 Some of the benefits of planning a review engagement are as follows.

Benefits of Planning

- Team members are properly briefed on the engagement objectives and expectations.
- Problem areas can be anticipated and surprises avoided.
- Review procedures are focused on areas of potential material misstatement.
- The engagement is properly organized, staffed and managed.

Ideally, the planning discussions would involve all of the engagement team but it is most important that senior engagement personnel be involved. The partner and senior staff usually have the most information about the entity and they are in a position for making the key decisions.

Planning Agenda Items

- Informing the team on what the entity is all about and what has changed this period.
- Discussion about where misstatements are most likely to occur and the appropriate response.
- Responses to specific concerns such as related-party transactions, complex estimates, litigation or claims and going-concern events / conditions.
- Any potential for improving the quality of file documentation and the efficiency / effectiveness of the review procedures performed.
- Any concerns identified during the preliminary engagement activities.
- Discussion on what staff will be required to do and why.

2.114 The results of the planning process should be documented in a planning memorandum and could include the following.

- Planning Documentation
- Nature of the engagement and any special requests.
- Guidance on what should be considered material.

- An overall strategy (significant risk factors to consider, timing and approach to the engagement).
- A detailed plan of action (the review procedures to be performed).
- Assignment of specific responsibilities to team members.

2.115 The core areas to consider in planning are as follows.

Planning Area Considerations

Understanding the Entity

- Discuss what the entity does, state of the economy and industry trends;
- Discuss the organizational structure and the roles of the board of directors, key personnel and state of their accounting knowledge;
- Identify any financial issues such as poor cash flow, bank covenants close to being breached, need for new capital investment or inability to attract people with the required skills;
- Identify any concerns regarding the choice and consistent use of accounting policies; and
- Identify and discuss those areas most susceptible to material misstatements in the financial statements.

Results of Previous Work Performed

- Where were misstatements identified and how were they resolved? These details about previous work can provide valuable insight on how the entity is managed and flag potential risks of material misstatement?
- What information was difficult to obtain or arrived late?
- Were there any matters noted in the file for carry forward or additional attention in this period?
- What was management's response to other matters bought to their attention?
- Engagement Efficiency
- Are there areas where we spent time unnecessarily or on insignificant matters or alternatively are there areas where we need to perform more work?
- Is there information that the client could be requested to prepare (i.e., saving our engagement time)?

Timing of Engagement

- What are the deadlines or timelines for engagement completion?
- When will the information to be prepared by the client be available?
- Who is available to perform the work at the required times, and is staff continuity possible?

Major Changes during Period

- What changes have taken place in the entity (such as changes in operations, information technology and business processes, key management, new financing activities and any acquisitions, mergers and divestments, etc.)?
- Have there been any changes in the financial reporting framework, such as accounting standards?

- Are there any other industry-specific matters to consider (such as new regulations, or competition, declining sales, obsolescence of products or availability of finance)?

Materiality and Risk Factors

- What would constitute a material misstatement with regard to the users of the financial statements?
- Were any new risk factors identified as a result of changes during the period?
- Are there any indicators that fraud may be taking place?

Consider Points

Staff briefings

- Brief staff about the entity and industry before they start work.
- Management does not like having to deal with new staff members who ask the same questions that other staff had already asked in the previous period.

Determine who to ask

- Identify the right people (those with the most information) to whom the review inquiries will be directed.

Assistance

- Ask management to prepare work papers, reconciliations, letters and analysis of balances where possible.

Automation

- Consider using a trial balance management program to perform time-consuming tasks such as posting journal entries, analytical comparisons, preparation of lead sheets and the financial statements.

Complete work in field

- Where applicable, ensure staff complete the work in the field before it comes back to the office for review. Going back to the entity at a later time and requesting additional information is inefficient.

The Four Planning Steps

2.116 The steps involved in developing an overall plan and strategy are illustrated below.

1	**Gather Information**
2	**Assess RMM at the Financial Statement Level**
3	**Develop Overall Responses**
4	**Develop Resource Management Plan**

RMM – Risks of Material Misstatement

Step 1 – Gather Information

2.117 The first step is to establish the scope of the engagement, reporting requirements and any significant changes that have taken place since the last engagement. Some factors to consider are outlined below.

The Scope of the Engagement
What characteristics will define the scope of engagement? Consider the following: • The financial reporting framework used; • Industry-specific reporting requirements; Need for a statutory audit of stand-alone financial statements in addition to an audit for consolidation purposes; • The availability of client personnel and data at the times required; Use of a service organization (such as for payroll, etc.) and

availability of evidence about internal control; and • Entity components and locations (if any) audited by other firms.
Reporting Requirements, Timing and Communications
What is required and when? Consider: • Timing of audit work and deadlines for issuing the audit report(s); • Communications and key dates for other auditors or third parties involved; and Key dates for expected communications with management and those charged with governance to discuss: • Status of audit work throughout the engagement; • The nature, timing, and extent of the audit work; and • Expected deliverables resulting from the audit procedures.

Requirements, Timing, and Communications

Important Factors for Audit Team to Focus on
Key factors to consider include: Lessons learned from prior experience and client acceptance and continuance procedures; • Determination of appropriate materiality levels; • Identification of areas where there may be higher risks of material misstatement; • Preliminary identification of material components and account balances; • Management's commitment to the design and operation of sound internal control, including documentation of such internal control;

• Potential for management override; • Evaluation of relevant internal controls • Discussions of audit matters with other firm personnel with knowledge of the entity; and • Effect of information technology (availability of paper trails, etc.) on the audit.
Significant Changes that will Impact the Audit Approach
What changes will impact the audit approach in the current period? Consider the following: • Changes in the financial reporting framework, such as accounting standards; • Entity-specific, industry, financial reporting, or other relevant developments; Business developments affecting the entity, including changes in information technology and business processes, changes in key management, and any acquisitions, mergers and divestments; and Industry developments such as changes in industry regulations and new reporting requirements.

Changes that will Impact the Audit Approach

Consider Point There may be some very small entities requiring an audit where the owner-manager runs the entity, has few (if any) formal documented controls in place, and can therefore override just about everything. In these situations, the auditor has to determine whether it is possible to perform an audit at all. If not, the auditor must exercise professional judgment in determining whether the engagement should be declined or a denial of opinion provided.

2.118 Factors to consider include:

- The entity's control environment. Is the owner trustworthy, competent and has a good attitude toward control? A competent owner-manager can often be control strength, as he or she will know the business, approve most transactions, and therefore be able to detect misstatements. However, the control weakness would create the potential for management override.
- Is it possible to develop further audit procedures that would respond appropriately to the assessed risk factors? The most difficult factor to determine is often what is not included (but should be) in the financial statements. For example, are all revenues and liabilities properly recorded in the accounting records?

Step 2 – Assess the RMM at the Financial Statement Level

2.119 The risks of material misstatement (RMM) at the overall financial statement level relate to the pervasive risks that affect the entity as a whole (such as nature of the industry, management's integrity, and their attitude toward control and competence). Risks at the assertion level generally relate to specific risks (such as high value of inventory or goods shipped but not invoiced) that occur at the business process level.

2.120 A preliminary assessment of the RMM at the overall financial statement level can be used to develop the preliminary overall audit strategy. The reason is that a low assessment of risk overall (appropriately documented) may be used to reduce substantive procedures required at the assertion level. Conversely, a high risk assessment would result in more work being required at the assertion level.

2.121 This preliminary assessment can be based on findings from the previous audit or as a result of performing risk assessment procedures in the current period.

2.122 The assessment of risk at the financial statement level can range from high to low. Some of the implications that flow from the risk assessment are outlined in the chart below.

Impact on Overall Audit Responses	
Risk Assessment is **LOW**	Some ability to place increased reliance on management representations and audit evidence generated internally by the entity. Greater potential for an audit approach that uses tests of internal controls as well as substantive procedures (combined approach). This should reduce the need for or extent of some substantive procedures. Ability to perform more audit procedures at an interim date rather than at period end.
Risk Assessment is **HIGH**	Emphasize to the audit team the need for an even higher level of professional skepticism in gathering and evaluating audit evidence. Consider the effectiveness of actions (if any) taken by management to address identified internal control weaknesses. Assign more experienced staff to the engagement team and consider the need to use experts. Ensure continuity of staff on the engagement to maximize knowledge of the entity. • Provide more staff supervision. • Obtain more extensive audit evidence from substantive procedures. Make changes to the analytical or other audit procedures applied as risk assessment procedures.

	• Modify the nature of audit procedures to obtain more persuasive audit evidence. Consider changes in the nature, timing, or extent of other audit procedures. • Obtain additional corroborative evidence for management representations.

Responses

> ***Consider Point***
>
> Consider communicating weaknesses in internal control to management (particularly in the control environment or entity level controls) before the year-end audit work commences. This communication provides management with an opportunity to take corrective action on a timely basis, which may improve the assessed level of audit risk. A recommendation to replace an old accounting software with the latest and more improved one or a recommendation to provide more training and support to the accounts department staff on working on the accounting software could help the entity improve control and result in less audit time being required at the period end.

Step 3 – Develop Overall Responses

2.123 The next step is to consider all the information obtained (in Steps 1 and 2 above) about the entity and the assessed risks to develop an overall audit strategy for conducting the engagement.

2.124 The overall audit strategy sets the scope, timing, and approach to the audit and guides the development of the more detailed audit plan.

Factors to Consider
Results from previous audit experience (including tests of controls that could be relied upon in the current period) and other assignments for the entity. • Response(s) by management to weaknesses identified in internal control. • The required staff resources and skills required for the audit. Consider need for experts to address complex, specific, and high-risk audit areas. • Audit timing, including inventory counts and other required procedures. • The most effective way to respond to the assessed risks of material misstatement at both the financial statement and assertion levels. • Effect of information technology (availability of paper trails, etc.) on the audit. • Management's commitment to the design and operation of sound internal control, including documentation of such internal control. • Potential for management override. • Need to introduce some unpredictability in performing audit procedures.

Step 4 – Develop a Resource Management Plan

2.125 SA 300 states:

"10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work (Ref: Para A15-A16)."

2.126 The final step in completing the overall audit strategy is to ascertain the nature, timing, and extent of resources necessary to perform the engagement.

Selecting the Engagement Team

- Does the proposed audit team have the necessary skill levels and resources?
- Have some team members been assigned supervisory responsibilities in the audit?
- Is there some continuity of staff on the engagement?
- Have audit tasks such as attending the inventory count and sending out confirmations before the year end been assigned to specific staff members?
- Has an engagement quality control reviewer been assigned (where applicable)?

Time Allocations

- Has a time budget been allocated to each team member for his or her assignments?
- Has time been set aside for areas where there may be higher risks of material misstatement?
- How much time is budgeted overall to complete the assigned work?

Communications

- Have roles, responsibilities and expectations of each audit team member been communicated?
- Have team members been reminded about the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence?
- Have dates for audit team meetings been set to discuss:
  - o Detailed audit plans and sharing information about the entity?

- o Identify possibility of fraud? (see paragraph 25 of SA 240)
- o Engagement deadlines and timing of file reviews?

- Have dates been established for fieldwork to commence (interim and year end) and other activities such as sending out confirmations, inventory count, and cut-off procedures?
- Have key dates been established for other auditors, experts, and third parties involved in the audit?

Management, Direction, and Supervision

- Has a plan been developed for:
  - o The day-to-day supervision of staff on the engagement?
  - o Senior staff being available to answer questions, respond to potential problems, and generally keep informed about progress?
  - o File reviews at either the entity's premises or in the office?
  - o Team debriefing meetings (where appropriate)?
- Is there a need for increased supervision and review as a result of a high level of assessed risk at the overall financial statement level?

Consider Point

In addition to the audit planning meeting at the start of the engagement it is highly desirable for the audit team (however small) to meet (or arrange a conference phone call) and discuss audit findings after performing:

- Risk assessment procedures; and
- Further audit procedures.

2.127 These debriefing sessions do not need to be formal or long, and enable audit team members to report verbally on their findings, exceptions found, and concerns noted. They can also report on any matters (however small) that seemed odd or did not make sense. It is often the small matters that, when combined with information obtained by other team members, point to a possible risk factor (such as fraud) that may require further work to be performed. Even when the audit team is just two people, these meetings can yield significant results. At the planning meeting, a time and date for these debriefing sessions can be scheduled.

Communicating the Plan with Management and Those Charged with Governance

2.128 The overall audit strategy and the detailed audit plan are entirely the auditor's responsibility. It is often useful to discuss elements of the detailed audit plan (such as timing) with management. These discussions often result in some minor changes to the plan to coordinate timing and facilitate performance of certain procedures. However, the exact nature, timing and scope of planned procedures should not be discussed in detail and should not be changed or scaled back to accommodate a management request. Such requests could compromise the effectiveness of the audit, make audit procedures too predictable, and could even constitute a scope limitation.

2.129 Where management reports to a separate group of people charged with governance, the overall audit strategy should be discussed with them or communicated in writing, including:

- Overall audit strategy;
- Timing of the audit; and
- Any additional requirements or limitations.

Documentation

2.130 SA 300 states:

"11. The auditor shall document:

(a) The overall audit strategy;

(b) The audit plan; and

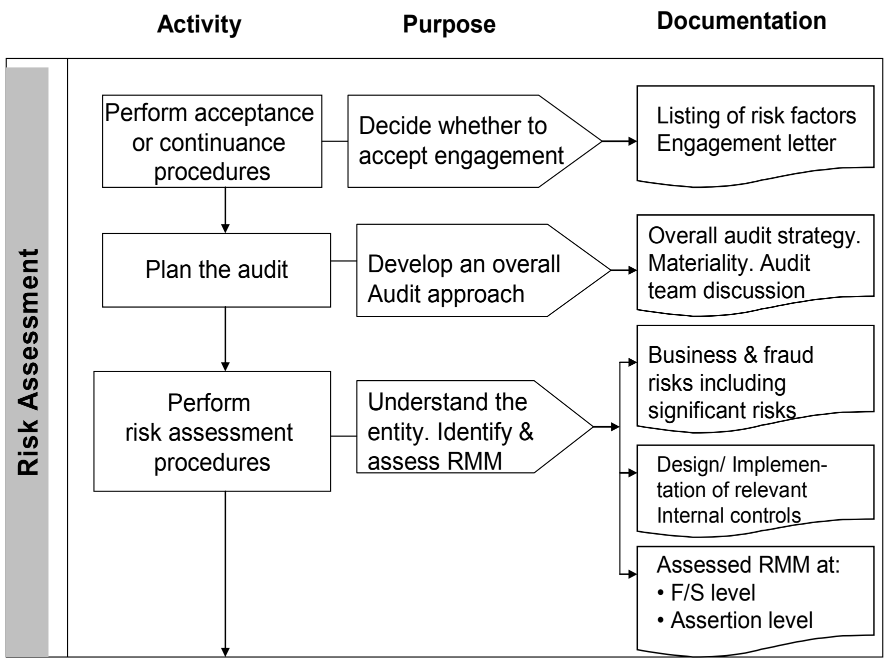
(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)"

The overall audit strategy and detailed audit plan, including details of any significant changes made during the audit engagement, should be documented.

2.131 The form and extent of documentation will depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement. It may take the form of a memorandum or a standard planning checklist.

Areas that documentation should address
• The key decisions (scope, timing, and conduct of the audit) considered necessary to properly plan the audit. • Information needed for communicating significant matters to the engagement team. • Planned nature, timing, and extent of risk assessment procedures and of further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. • Reasons for significant changes to the original strategy, such as responding to new events and conditions or the results of performing audit procedures. Also include details of the revised/further procedures performed as a result. • Identification of a temporary materiality level and relevant sampling factors such as confidence levels planned and used.

Business Risks



The purpose of this Section is to provide guidance on the identification and assessment of business risks. The primary source of reference for this is SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

Overview

2.132 SA 315 states:

"24. The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

2.133 The assessment of the risks of material misstatement is made at the:

- Financial statement level; and
- Assertion level for classes of transactions, account balances, and disclosures. This section focuses on the identification and assessment of business risks resulting from the performance of risk assessment procedures.

Risk Factors

2.134 An understanding of business risks increases the likelihood of identifying the risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

2.135 Business risks result from conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies.

Consider Point
It is best to separate the identification of risks from their assessment. As business risks can be identified during any stage of the engagement, the audit team should be encouraged to document them in a single place (for ease of reference and review) before they are assessed. This will ensure that all risks are documented and considered, even if some of the risks identified are later assessed as being insignificant and requiring no further work.

2.136 The chart below outlines some examples of risk factors that may indicate the existence of risks of material misstatement.

Source of Risk Factors	
External Factors	• State of the economy and government regulation; • High degree of complex regulation; • Changes in the industry in which the entity operates; • Changes in the supply chain; • Declining demand for the entity's products or services; • Inability to obtain required materials or the personnel with skills required for production; • Deliberate sabotage of an entity's products or services; and • Constraints on the availability of capital and credit.
Business	• Operations in regions that are

Strategies	economically unstable; • Operations exposed to volatile markets; • Developing or offering new products or services, or moving into new lines of business; • Entering into business areas/transactions with which the entity has little experience; • Setting of inappropriate or unrealistic objectives and strategies; • Aggressive expansion into new locations; • Acquisitions and divestitures; • Complex alliances and joint ventures; • Use of complex financing arrangements; • Corporate restructurings; and • Significant transactions with related parties.
Entity's Organization	• Poor corporate culture and governance; • Incompetent personnel in key positions; • Changes in key personnel including departure of key executives; • Complexity in operations, organization structure and products; o Failure to recognize the need for change such as in skills required or the use of technology; o Response to rapid growth or decline in sales that can strain internal control systems and people's skills; • Lack of personnel with appropriate accounting and financial reporting skills;

	• Weaknesses in internal control, especially those not addressed by management; and • Inconsistencies between the entity's IT strategy and its business strategies.
Other	• Product or service flaws that may result in liabilities and reputation risk; • Relationships with external funders, such as banks; • Going-concern and liquidity issues including loss of significant customers; and • Installation of significant new IT systems related to financial reporting.

The Entity's Risk Assessment Process

2.137 Risk assessment is one of the five components of internal control that the entity should be using for:

- Identifying business risks relevant to financial reporting objectives; and
- Forming the basis for how management will determine what risks to manage.

2.138 In smaller entities, the risk assessment process is likely to be informal and less structured. Risk in these entities is often recognized implicitly rather than explicitly. Management may be aware of risks related to financial reporting through direct personal involvement with employees and outside parties. As a result, the auditor will make inquiries of management as to how they identify and manage risk, what risks have been identified and managed, and then document the results.

Consider Point

When risk factors are documented and assessed by the auditor, it is important that the results are discussed with management of the entity. This will help to ensure that a significant risk factor has not been overlooked and that the assessment of risks (likelihood and impact) is reasonable.

As management understands the benefits of a more formalized risk assessment process, they may decide to develop, implement, and document their own processes. When this occurs the auditor is required to evaluate its design and implementation. This involves determining how management:

- Identifies business risks relevant to financial reporting;
- Estimates the significance of the risks;
- Assesses the likelihood of their occurrence; and
- Decides upon actions to manage them.

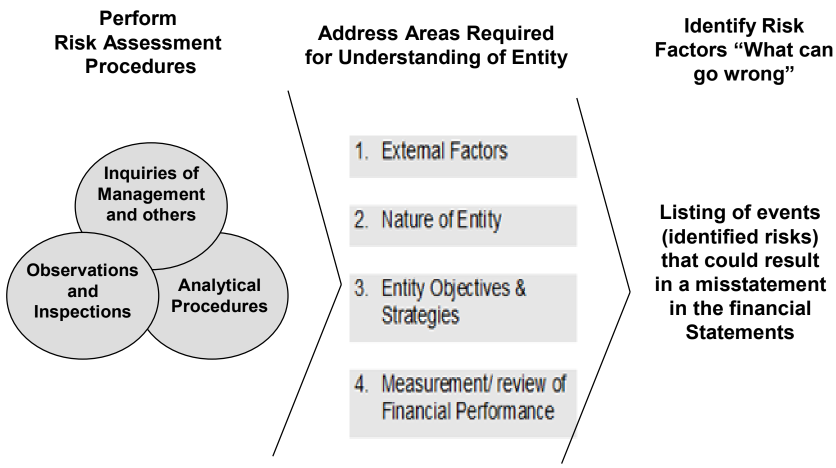
2.139 In addition to considering the entity's process, the auditor should also inquire about:

- Business risks that management has identified and whether they may result in material misstatement; and
- Business risks that management may have failed to identify under the entity's process. If additional risks are found, consideration should be given as to whether there is a material weakness in the entity's risk assessment process, which should be communicated to those charged with governance.

Identification of Risks

2.140 Risk identification is derived from information gathered in performing the three risk assessment procedures. First, identify risks without consideration of any internal control that might mitigate such risks. Separately assessing risks before considering the internal control system will help to identify any significant risks and provide the necessary basis for assessing the design and implementation of management's internal control.

2.141 The risk identification process is illustrated in the exhibit below.



2.142 For each risk identified, the auditor would carefully consider:

- **What are the implications?**

2.143 What type of misstatement could occur in the financial statements as a result of the risk? For example, if the entity handles diamonds there is a high level of inherent risk (that is, before consideration of any internal control) that it could be stolen. The implication of this risk is the possibility that the diamonds inventory in the financial statements might not exist (existence assertion) or the value may be misstated (valuation assertion). This question becomes even more difficult for pervasive risks where the possibilities for misstatement could be numerous. For example, if those charged with governance were ineffective, all sorts of misstatements (deliberate or otherwise) could potentially go unnoticed.

- **What financial statement areas and assertions are affected?**

2.144 To what specific classes of transactions, account balances, and disclosures and related assertions does the risk relate? Note that a number of the risks identified will be pervasive across the entity, as they cannot be related to specific areas or assertions. For example, the failure of the entity to set objectives and operating budgets could result in various types of errors being missed. Another example would be an incompetent bookkeeper/accountant. These risks cannot easily be allocated to specific financial statement areas or disclosures.

2.145 Pervasive risks often derive from a weak internal control environment and potentially affect many financial statement areas, disclosures, and assertions. These risks will likely affect the assessment of risk at the financial statement level and require an overall response (such as more audit work, assigning more experienced staff members, etc.) by the auditor.

2.146 Avoid the temptation to only list risk factors that are likely to be significant or important. A key part of risk or event identification is to develop as complete a listing of risk factors as possible. Inconsequential risk factors can always be removed later after each risk is appropriately assessed. This will help to ensure that all material risks are indeed identified.

2.147 As the audit progresses, additional risks may be identified. These should be added to the list of identified risks and appropriately assessed before making a decision as to any further audit procedures required.

Assessment of Risks

2.148 After the auditor has identified the risk factors and the types of misstatement in the financial statements that could result, the next step is to assess or rank their significance. Again, it is preferable to assess these risks before consideration of any internal control that mitigates the risks.

2.149 For each identified risk consider:

- Likelihood of risk occurrence; and
- Monetary impact of risk occurrence.

Likelihood of risk occurrence

2.150 What is the probability that the risk will occur? The auditor can evaluate this probability simply as high, medium, or low or by assigning a numerical score, such as 1 to 5. The higher the score, the more likely the risk could occur.

Monetary impact of risk occurrence

2.151 If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount. If not, different people (with different amounts in mind) could come to entirely different conclusions. For audit purposes, the specified amount would relate to what constitutes a material misstatement of the financial statements. This can also be evaluated simply as high, medium, or low or by assigning a numerical score, such as 1 to 5.

2.152 Numeric scores for the likelihood and impact can be multiplied to give a combined or overall score. This can be helpful in sorting the risks in order of importance.

2.153 Using a simple format within an electronic worksheet can be an efficient way of conducting this step. The risks can then be sorted so that the most significant identified risks are at the top of the list.

2.154 The “risk register” below provides a sample format for identifying and assessing risks.

Risk Register

Entity ABC Co.
Risk Tolerance for Materiality 2500e

S.No.	**Risk Factor**	**Assertions Addressed**	**Risk Assessment**		
			Likeli-hood	**Impact**	**Comb**
			1-5	**1-5**	**Li x Lm**
1	New technology is significantly reducing production costs on some products	Inventory or older products could become obsolete and therefore overvalued.	3	4	12
2	New environmental law is being introduced	New liabilities and contingent liabilities will be created for environmental clean-up costs.	2	4	8
3	New accounting system is being introduced	Errors could occur during the changeover that would not be prevented or detected.	4	2	8
4	Senior production manager is retiring	Not finding a suitable replacement could result in many types of mistakes being made.	3	2	6
5	Significant management bonuses based on sales	Pressure could exist to inflate sales to ensure bonus threshold is achieved.	2	2	4

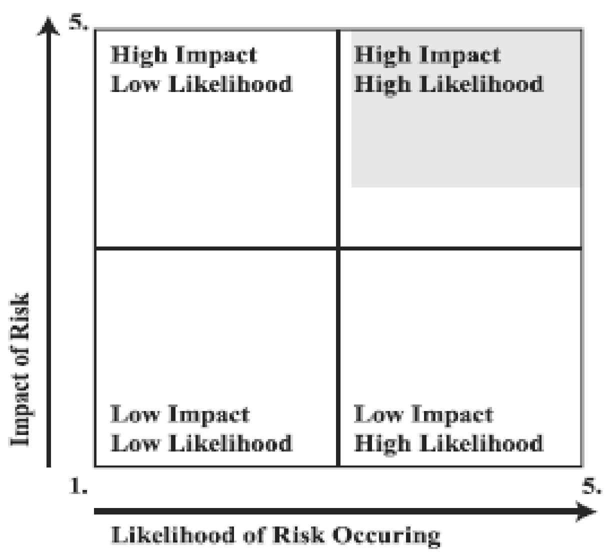
Comb – Combined risk score

Note: An additional column can also be added to the above format to identify or cross-reference the internal control or steps taken by management to mitigate the risk

Consider Point

The most important, but also the most difficult, column to complete on the above form is "What can go wrong in the financial statements (F/S) as a result". It is in this column that the auditor sets out the implication of the identified risk. Declining sales is a risk factor but if recorded accurately by the entity, this would not result in risks of material misstatement. However, declining sales could result in inventories being obsolete or overvalued and receivables may become difficult to collect. It is the implication of each risk factor that the auditor needs to identify so that an appropriate audit response (such as further audit procedures) can be developed.

2.155 The results of the risk assessment process can also be set out in a chart, as illustrated below.



2.156 Risks falling in the "high impact, high likelihood" area of the chart clearly require management action to mitigate. In addition, these will likely be determined as being significant risks, which require special audit consideration.

Documentation of Risks

2.157 The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Documentation may be memoranda or forms may be used to ensure information is captured in a structured format. Often the auditor will use a mixture of both formats – memoranda and forms.

Consider Point

2.158 A key point to consider is how the documentation will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

2.159 Using a "risk register" such as the example above helps to ensure all risks are documented in a central place and are assessed in a consistent and systematic manner. When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score.

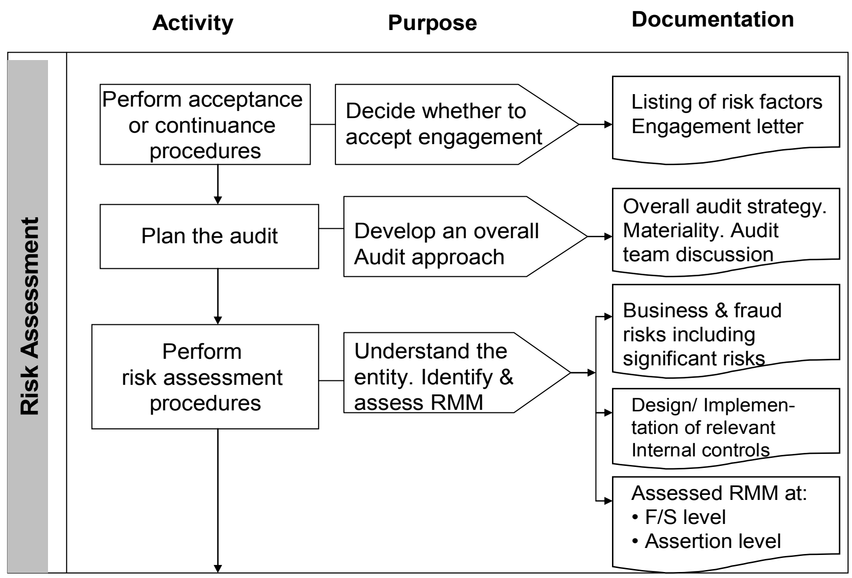
2.160 A structured format helps to ensure:

- Consistent basis for risk assessment and identifying significant risks;
- Ease of review;
- Ability to sort risks using various criteria; and
- Ability for the auditor to share the list with the client for their input or request that the client prepare it for the auditor's review.

2.161 The more complex the entity and the audit procedures required, the more extensive the documentation required.

Note: The auditor should use his/her professional judgment regarding the manner in which these matters are documented.

Fraud Risks



2.162 The purpose of this Section is to outline the auditors' role in assessing risk factors that could result in financial statement fraud and misappropriation of assets. The primary source of reference for this is SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

Overview

2.163 SA 315 states:

"3. 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, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A12-A14)

A12. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- *…*

- *Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.*

24. The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

2.164 SA 240 states:

"10. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.

12. In accordance with SA 200 (Revised), the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

17. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

20. Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

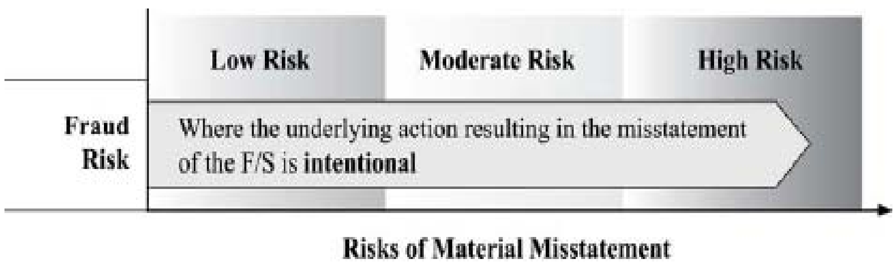
21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate *the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)"*

2.165 The risk assessment described in this Section focuses on the auditor's responsibility to consider fraud that causes a material misstatement in the financial statements. This is described in SA 240 but still forms part of the overall risk assessment performed in accordance with SA 315.



Fraud

2.166 The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

2.167 Fraud involving one or more members of management or those charged with governance is referred to as "management fraud". Fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion within the entity or with third parties outside of the entity.

2.168 The table below outlines the types and characteristics of fraud.

Types and Characteristics of Fraud

	Misappropriation of Assets (Converting Assets to personal use)	**Manipulation of F/S (reporting a higher/lower level of earnings than actually occurred)**

Who?	Management	Employees	Management	Employees
Pressures	Personal benefit	Personal benefit	Personal benefit such as saving taxes, selling business at an inflated price or justifying a bonus	Personal benefit such as meeting a performance based threshold for a bonus
Opportunities	Override of functioning internal control (IC) Exploit weakness in internal control	Exploit weakness in internal control	Override of functioning internal controls Exploit weakness in internal control (IC)	Exploit weakness in internal control (IC)
Amounts Involved	Tend to be large due to position in entity and knowledge of IC	Often small but could potentially be large	Tend to be large due to position in entity and knowledge of IC	Size would be relative benefit (bonus) paid

2.169 Although fraud can occur at any level in the organization, it tends to be more serious (and involve higher monetary amounts) when senior management is involved.

2.170 Some of the major conditions that create an environment for fraud include:

- Ineffective corporate governance;
- Lack of leadership and "tone at the top" by management;
- High incentives provided for financial performance;

- Complexity in entity rules, regulations, and policies;
- Unrealistic budget targets for staff to attain; and
- Inadequate internal control, especially in the presence of organizational change.

2.171 As can be determined from the above, the most effective anti-fraud internal control would be a strong commitment by those in governance and senior management to doing the right thing. This is evidenced through articulated entity values and a commitment to ethics that are modelled on a day-to-day basis. This is true for any size of organization.

The Fraud Triangle

2.172 The nature of fraud outlines the following three conditions that often provide clues to its existence. Forensic accountants often refer to this as the "fraud triangle" because when all three conditions are present, it is highly likely that fraud may be occurring.

2.173 The conditions are:

- **Opportunity**

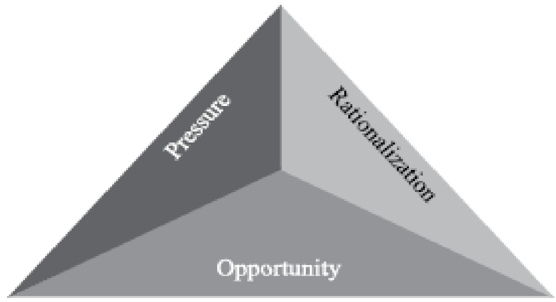
A poor corporate culture and a lack of adequate internal control procedures can often create the confidence that a fraud could go undetected.

- **Pressure**

This is often generated by immediate needs (such as having significant personal debts or meeting an analyst's or bank's expectations for profit) that are difficult to share with others.

- **Rationalization**

Rationalization is the belief that a fraud has not really been committed. For example, the perpetrator rationalizes "this is not a big deal" or "I am only taking what I deserve".



2.174 In conducting risk assessment procedures, the audit team members may identify a fraud risk factor that relates to one of the triangle elements. However, it is less likely that any one auditor will identify all three conditions (opportunity, pressure, rationalization) together. For this reason, it is very important for the audit team to continually discuss their findings throughout the engagement.

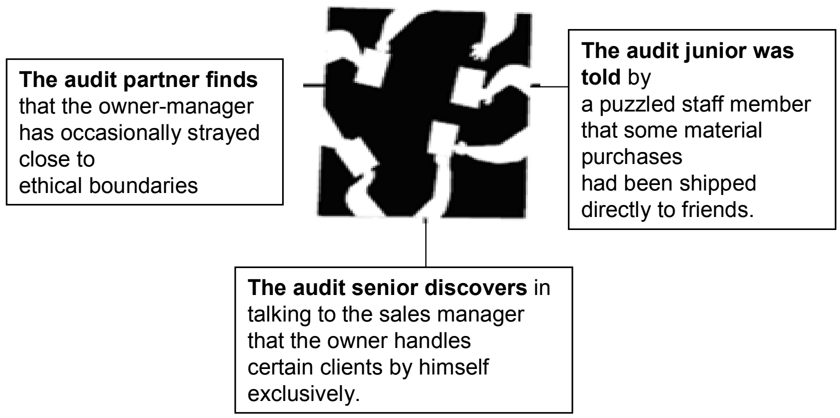
2.175 For example, an owner-manager in the construction business may offer to build a significant addition to a friend's house for a good price, as long as it is a cash-only transaction with no paperwork involved. Because of the owner-manager's position, the opportunity exists for him or her to override the internal controls over revenue recognition and not record the revenue from the sale. The pressure might be to reduce taxes that would otherwise be payable and the rationalization would be that he or she is paying far too much in taxes already. In conducting risk assessment procedures, the auditor may discover several findings.

Audit Team Discussions

2.176 An important part of gathering information about fraud risk factors and effectively utilizing the firm's knowledge of the entity is sharing that information with the other members of the audit team. Encourage team members to come to the meeting with a questioning mind, setting aside any beliefs (possibly built over a number of years) that management is honest and has unquestioned integrity.

2.177 The benefits of audit team discussions are outlined in the exhibit below.

Benefits of Audit Team Discussions



2.178 In the absence of communication, it would be difficult for any member of the above audit team to see the big picture. However, the audit team discussion allows them to pull the different pieces of information together so that the bigger picture can indeed be seen. Fraud is always intentional and involves concealment of information. Its detection is often discovered by looking for patterns, oddities, and exceptions in what might be very small monetary amounts.

Professional Skepticism

2.179 It is the responsibility of auditors to maintain an attitude of professional skepticism at all times during the engagement. An attitude of professional skepticism involves:

- Making critical assessments, with a questioning mind, of the validity of audit evidence obtained;
- Being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance; and

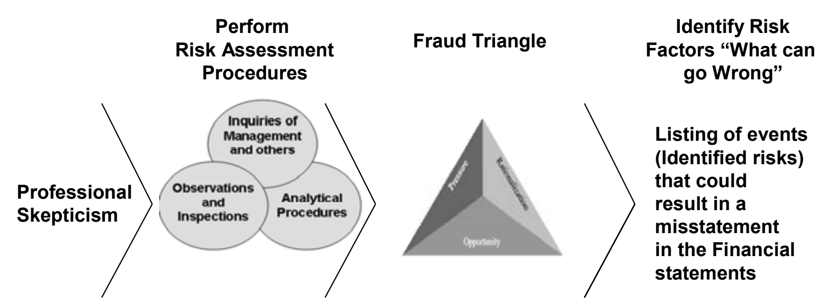
- Recognizing that management is always in a position to override otherwise good internal control.

2.180 In conducting their work, auditors need to be careful to avoid:

- Overlooking unusual circumstances;
- Over-generalizing when drawing conclusions from audit observations;
- Using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof;
- Accepting less than persuasive audit evidence on a belief that management and those charged with governance are honest and have integrity; and
- Accepting representations from management as a substitute for obtaining sufficient appropriate audit evidence.

Identification of Fraud Risk Factors

2.181 Because fraud is concealed and management override is always a possibility, auditors need to carefully consider all the information obtained from performing the three risk assessment procedures and have regular discussions among the audit team, as illustrated below.



2.182 These procedures will include gaining an understanding and consideration of the "tone at the top" or management's attitudes toward the internal control environment. For example:

- How do those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud?
- How does management address the design and implementation of internal control to mitigate these risks? In smaller entities, management may consciously choose to accept the risk associated with a lack of segregation of duties due to high levels of day-to-day supervision of operations.
- Is there actual, suspected or alleged fraud affecting the entity and has management discovered any material errors?
- What perspective do persons other than the owner or senior management have on the culture, management operating style, management override, and existence of fraud risk factors?
- Are there specific areas of vulnerability such as management estimates, revenue recognition, use of journal entries, transactions with related parties, etc.?

2.183 This understanding of the entity should also include the internal control over financial reporting.

Examples of Fraud Risk Factors

2.184 The fraud risk factors identified in Appendix 1 of SA 240 (summarized in the following chart for smaller entities) are examples of such factors typically faced by auditors in a broad range of situations.

Fraudulent Financial Reporting	
Tone at the Top Pertains to management's abilities, pressures, style and attitude relating to internal control and the financial reporting process.	**1. Pressures** • Bonuses A significant portion of management or staff's compensation is represented by bonuses (or other incentives), the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow. • Forecasts Management commits to financial institutions, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts. • Tax reduction Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
	2. Opportunities • Management's attitudes Failure by management to display/communicate an appropriate attitude regarding internal control and the financial reporting process such as: o Management does not effectively communicate and support the entity's values or ethics or Management communicates inappropriate

	values or ethics; o Management is dominated by a single person or a small group without the compensating internal control such as effective oversight by those charged with governance; o Management does not monitor significant internal control procedures adequately; o Management fails to correct known material weaknesses in internal control on a timely basis; o Management sets unduly aggressive financial targets and expectations for operating personnel; o Management displays a significant disregard for regulatory authorities; and o Management continues to employ ineffective accounting and/or information technology staff. • Turnover There is a high turnover of management, legal counsel or board members. • Management/auditor relationships There is a strained relationship between management and the current/predecessor auditor such as:

	o Frequent disputes on accounting, auditing, or reporting matters; o Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report; o Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information or limit the auditor's ability to communicate effectively with those charged with governance; and o Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work. • Corporate governance structure The corporate governance structure is weak or ineffective as evidenced by inexperience or lacking members, members who are not independent of management or where little attention is being paid to financial reporting matters and accounting and internal control systems.
Industry Conditions Pertains to the economic and regulatory	• New compliance requirements New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.

environment in which the entity operates.	• Operational challenges A high degree of competition or market saturation, accompanied by declining margins. • Industry trends o A declining industry with increasing business failures and significant declines in customer demand; and o Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
Operating Characteristics and Financial Stability Pertains to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.	• Cash flows o Inability to generate cash flows from operations while reporting earnings and earnings growth; and o Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures). • Estimates o Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties; and o Estimates subject to significant change in the near term that

	may have a financially disruptive effect on the entity (such as collectibility of accounts receivable, valuation of inventory, timing of revenue recognition. or a significant deferral of costs). • Related parties o Significant related-party transactions which are not in the ordinary course of business; and o Significant related-party transactions which are not audited or are audited by another firm. • Complexity o Significant, unusual or highly complex transactions (especially those close to year end) that pose difficult questions concerning substance over form; o Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification; • Reporting o An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority; or contractual arrangements without apparent

	business purpose; and o Difficulty in determining the organization or person (or persons) controlling the entity. • Growth/profitability Unusually rapid growth or profitability, especially compared with that of other companies in the same industry. • Dependencies/vulnerabilities o Especially vulnerable to changes in interest rates; o Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain; o Unrealistically aggressive sales or profitability incentive programs; o A threat of imminent bankruptcy, foreclosure; or hostile takeover; o Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported; and o A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Misappropriation of Assets	
Susceptibility of Assets to Theft	• Large amounts of cash on hand or processed; • Inventory characteristics, such as small size combined with high value and high demand; • Easily convertible assets, such as bearer bonds, diamonds, or computer chips; and • Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.
Absence of Internal Control	• Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations); • Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation; • Inadequate record keeping for assets susceptible to misappropriation; • Lack of an appropriate segregation of duties or independent checks; • Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing); • Poor physical safeguards over cash,

	investments, inventory or fixed assets; • Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns); and • Lack of mandatory vacations for employees performing key internal control functions.

Assessment of Fraud Risk

2.185 Once the fraud risk factors have been identified (from performing risk assessment procedures), the next step is to assess the likelihood of the risk occurring and whether it could result in a material misstatement in the financial statements. The same risk assessment procedures should be followed as for business risks.

Documentation

2.186 The auditor should document the fraud risk factors identified and their assessment. When deciding what form of documentation is required, consider how it will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

Consider Point

2.187 Separate the listing of fraud risk factors from business risks. Some business risks, such as complex financing arrangements, could result in simple errors being made but could also be used to conceal fraud. It is preferable to document assessed business and fraud risks separately.

2.188 The same 'risk register' for business risks can be used to document fraud risk factors. A simple example is provided below.

Risk Register - Fraud

Materiality 15,000% Assess each risk in terms of likelihood and impact on a scale of 1-5 (1st low, 5th high) Discuss this worksheet (risk register) with management to ensure completeness and appropriateness of the risk assessment								
Risks Identified	What would go Wrong in the F/S as a Result	**FSA Impact – CEAV**		Inc.	**Risk Assessment**		Combined Risk	Significant risk? Y/N
		Assets	Liabilities		Likelihood to occur	impact		
Cash flow is tight due to late delivery on a major contract. Problems will take some time to rectify	Owner manager may try to cover up losses on contract to avoid more tough questions from the bank	EV	C	A	3	3	9	No
Sales targets for bonuses may be narrowly missed this year by a number of salespersons	Sales persons may be tempted to inflate their sales revenue to ensure targets are met	EV		C	3	3	9	No
Inconsistency in revenue recognition	Revenues could be inflated or recorded in the wrong period	ECA		ECA	4	5	20	Yes

Note: Revenue recognition is considered a significant risk that will require special attention.

2.189 When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score. Professional judgment should be used regarding the manner in which these matters are documented.

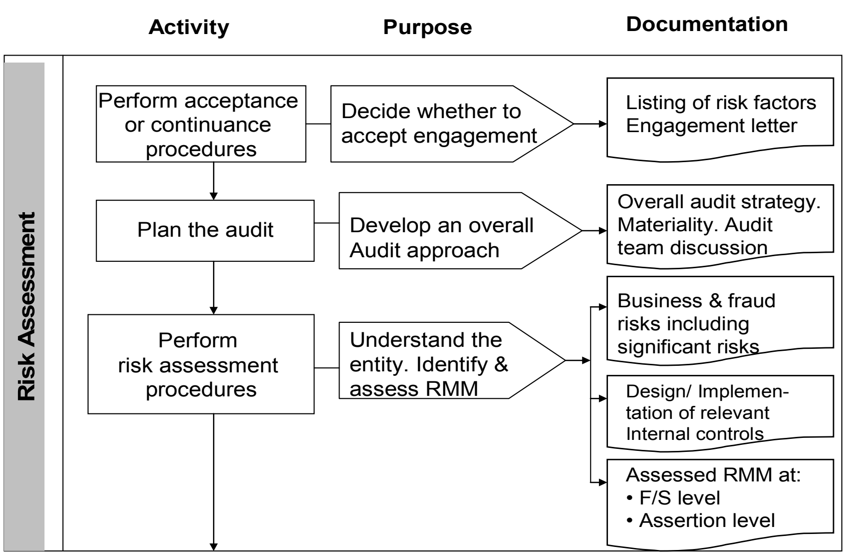
Consider Point

2.190 Maintain separate lists for business risk factors and fraud risk factors. Note that some business risk factors will also be fraud risk factors. For example, revenue recognition is included on the business/operating "risk register" and on the fraud risk register above.

2.191 This separation is also helpful in:

- Identifying possible pressures, opportunities, and rationalizations for fraud;
- Identifying the susceptibility of particular account balances and transactions to fraud; and
- Designing an appropriate audit response.

Significant Risks



2.192 The purpose of this Section is to provide guidance on the nature and determination of significant risks and the consequences for the audit. The primary source of reference for this is SA 315.

Overview

2.193 SA 315 states:

"24. The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A117-A119)"

2.194 SA 240 states:

"29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

(b) *Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and*

(c) *Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)"*

2.195 SA 330 states:

"6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as appropriate and notwithstanding the requirements of this SA), the auditor may determine that:

(a) *Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;*

(b) *Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or*

(c) *A combined approach using both tests of controls and substantive procedures is an effective approach."*

Determination of Significant Risks

2.196 A key part of the risk assessment process is to determine which of the business and fraud risks identified are, in the auditor's judgment, significant.

2.197 Significant risks will:

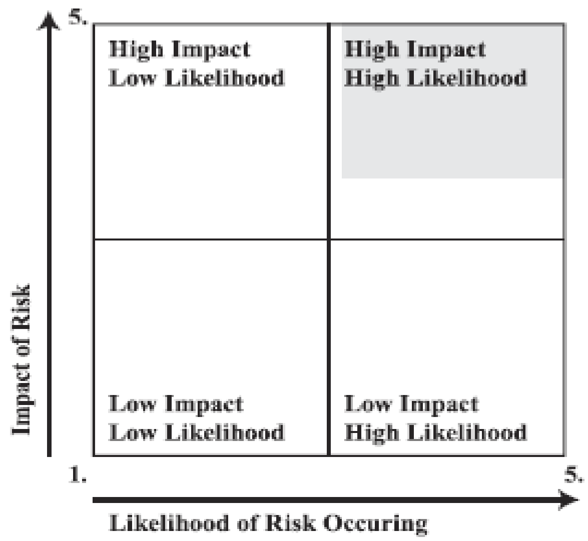
- Arise on most audits; and
- Require special audit consideration.

2.198 Determination of which risks are significant is based on:

- The nature of the risk;
- Consideration of the effect of any identified internal control related to the risk;
- The likely magnitude (size) of the potential misstatement (or multiple misstatements); and
- The likelihood (probability) of the risk occurring.

2.199 Note that the determination of significant risk is based on the inherent risk (before considering related internal control) and not the combined risk (considering both inherent and internal control risks). For example, a company with a large inventory of diamonds would have a high inherent risk of theft. Management's response is to maintain secure facilities and keep the diamonds locked in a safe that is guarded at all times. The combined risks of material misstatement are therefore minimal. However, because the risk of loss (before considering internal control) is highly likely and its size would have a material impact on the financial statements, the risk would be determined as "significant".

2.200 A chart that maps the assessment of risks based on likelihood and impact. Risks that fall within the shaded area of the chart below (high impact, high likelihood) would certainly be considered as being significant risks.



Areas to Consider

2.201 When considering whether significant risks exist, the auditor would consider the following matters:

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- The degree of subjectivity in the measurement of financial information related to the risk, especially those involving a wide range of measurement uncertainty; and
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

2.202 In smaller entities, significant risks often relate to the matters outlined in the chart below.

Subject Matter/ Information	**Characteristics**
Significant Non-routine Transactions	• High inherent risk (likelihood and impact). • Occur infrequently. • Not subject to systematic processing. • Unusual due to their size or nature (such as the acquisition of another entity). • Require management intervention: o To specify accounting treatment; and o For data collection and processing. • Involve complex calculations or accounting principles. • Nature of transactions makes it difficult for entity to implement effective internal controls over the risks.
Significant Judgmental Matters	• High inherent risk. • Involve significant measurement uncertainty (such as the development of accounting estimates). • Accounting principles involved may be subject to differing interpretation (such as preparation of accounting estimates or application of revenue recognition). • Required judgment may be subjective, complex, or require assumptions about the effects of future events (such as judgments about fair value, valuation of inventory subject to rapid obsolescence, etc.).

2.203 The auditor should also consider the following factors when identifying significant risks:

- Is there a potential for fraud to occur?
- Is the risk related to recent significant economic or accounting changes or other developments?
- Are complex transactions involved?
- Are there significant transactions with related parties?
- Is there a high degree of subjectivity in the measurement of financial information, especially those areas involving a wide range of measurement uncertainty?
- Are there significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual?

Responding to Significant Risks

2.204 When a risk is classified as being "significant", the auditor should respond as outlined below.

Evaluating Internal Control Design and Implementation

2.205 The auditor should evaluate the design of the entity's related internal control system, including relevant internal control activities, and determine whether they have been implemented. This is necessary to provide the auditor with adequate information to develop an effective audit approach.

2.206 Internal control activities could include:

- A review of assumptions (used in estimates) by senior management or experts;
- A formal process for preparing estimations; and
- Approval of the response by those charged with governance.

2.207 Where significant non-routine or judgmental matters are not subject to routine internal control (such as a one-off or an annual event), the auditor should evaluate management's awareness of the risks and the appropriateness of their response. For example, if the entity purchased the assets of another business, the entity's response might include hiring an independent valuator for the acquired assets, the application of appropriate accounting principles, and proper disclosure of the transaction in the financial statements.

2.208 Where the auditor judges that management has not appropriately responded (by implementing internal control over significant risks) and a material weakness exists in the entity's internal control:

- The matter should be communicated (as soon as possible) to those charged with governance; and
- Consideration should be given to the implications for the auditor's risk assessment (determining the further audit procedures may be required to address the assessed risk).

Reliance on evidence attained in previous audits not allowed

2.209 Where a test of operating effectiveness is planned for a control that mitigates a significant risk, the auditor may not rely on audit evidence about the operating effectiveness of internal control obtained in prior audits.

Substantive procedures should specifically respond to the identified risk

2.210 Substantive procedures related to significant risks should address the specific risk identified. They should also be designed to obtain audit evidence with high reliability.

2.211 In many cases, the audit procedures for significant risks will be an extension of procedures that would be planned in any case. For example, if the significant risk related to potential management bias lies in the preparation of an estimate, the substantive procedures would address the validity of the assumptions used, identifying the sources and considering the reliability of the information used (both external and internal), the existence of any bias in the prior year's estimates as compared to actual facts, and the methods used in the estimate calculation.

Substantive analytical procedures alone are not a sufficient response

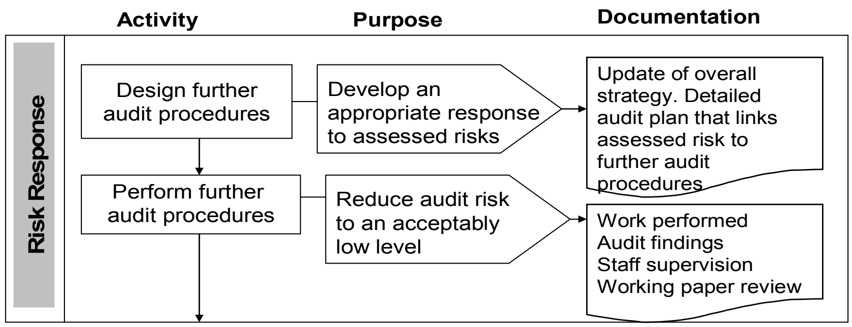
2.212 The use of substantive analytical procedures by themselves is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures can consist of:

- Tests of details only; or
- A combination of tests of details and substantive analytical procedures.

Part C
Risk Response

Chapter 3
Risk Response

Detailed Audit Plan



3.1 The purpose of this Section is to respond to the identified risks of material misstatement by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. The primary source of reference for this is SA 300, “Planning an Audit of Financial Statements”.

Overview

3.2 SA 300 states:

“8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 “The Auditor’s Responses to Assessed Risks”.

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

11. The auditor shall document:

(a) The overall audit strategy;

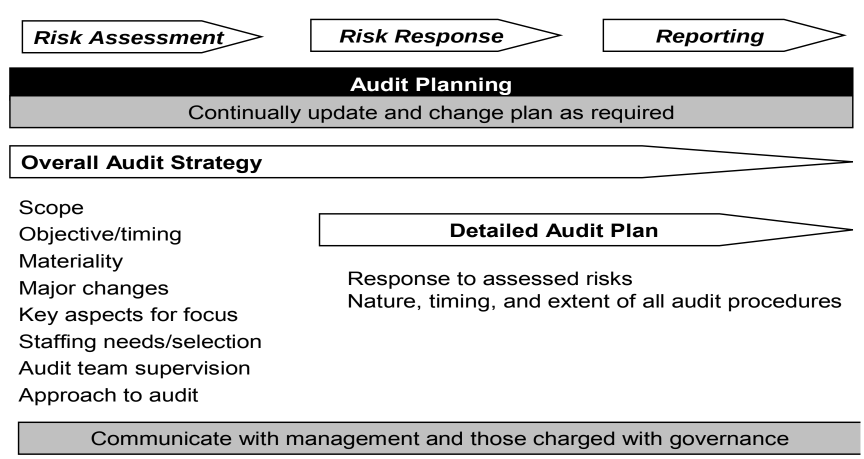
(b) The audit plan; and

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)"

3.3 The overall audit strategy sets out the scope, timing, and direction of the audit and guides the development of the more detailed audit plan, which is discussed in this section. The more detailed audit plan addresses the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

3.4 Although the overall audit strategy will be established before developing the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes. They are closely interrelated since changes in one may result in consequential changes to the other.

This is illustrated below.



3.5 The objective of the detailed audit plan is to respond appropriately to the identified and assessed risks, thereby reducing audit risk to an acceptably low level.

3.6 The detailed plan:

- Provides a clear linkage between the assessed risks and the further audit procedures; and
- Outlines the nature, timing, and extent of such further audit procedures (tests of controls and substantive procedures).

Consider Point

3.7 The detailed plan should link the design of further audit procedures to the assessed risks addressed during the risk assessment phase of the audit. This "linkage" is quite different from some traditional audit approaches where standard audit programs were completed with few, if any, changes made to reflect the specific risks present within the entity.

Responding to Assessed Risks

3.8 The nature, timing and extent of further audit procedures should:

- Respond to the assessed risks (identified during the risk assessment process);
- Reduce audit risk to an acceptable level; and
- Respond to assessed risks of material misstatements for each material class of transactions, account balance, and disclosure.

3.9 The basic information and considerations needed to design further audit procedures include:

- Nature of assessed risks;
- Use of tests of controls;
- Need for unpredictability; and

- Other basic or required audit procedures.

These are discussed as follows.

Nature of Assessed Risks

3.10 Audit attention should be directed in responding to those risks that have the highest potential for material misstatement. Considerations include:

- *How significant is the assessed risk?*

  What would be the impact if it occurred? This would relate to materiality.

- *How likely is the assessed risk to occur?*

  What is the likelihood or probability of the risk actually occurring?

- *What is combined assessment of impact and likelihood?*

- *What assertions are effected?*

  Consider the impact of the risk on each of the assertions (completeness, existence, accuracy, and valuation) relevant to the account balance, class of transactions, or disclosure.

- *Is it a "significant risk"?*

  Significant risks require separate attention and response by the auditor. Planned audit procedures should directly address these risks.

- *What is management's response?*

  Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Are the controls:

  - Routine in nature (occur daily) or periodic such as monthly?
  - Designed to prevent or detect and correct errors?

- o Manual or automated?

- *Are there any unique characteristics?*

  Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures. Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Use of tests of controls

The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In the case of very small entities, there may not be many control activities that could be tested. In this case, the further audit procedures are likely to be primarily substantive.

There are two matters to consider when determining whether the response to assessed risks should include testing the operating effectiveness of internal control.

- *Is it efficient to test internal control?*

  Where internal control exists and is expected to operate effectively, consider:

  - o Whether testing controls would achieve an effective response to the assessed risk of material misstatement for a particular assertion; and

  - o What substantive testing could be reduced by performing tests of controls.

Even in a very small entity, there are often well-designed and effective controls over revenues that, if tested, could reduce the extent of substantive procedures required.

If testing the operating effectiveness of internal control would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to assessed risks for specific assertions. No credit can be taken for the effective operation of controls that have not been tested.

- *Are there assertions that can only be effectively addressed by tests of controls?*

  In some cases, suitable substantive procedures (to obtain evidence for a particular assertion) may not be available, so tests of controls will be necessary. An example of this would be highly automated systems with little or no paper trail available. If such internal control is not considered reliable (controls are not likely to operate effectively) or is absent, the auditor will have to determine whether it is possible at all to obtain sufficient appropriate audit evidence.

Need for unpredictability

3.11 Based on the nature of the assessed risks, consider whether some of the planned procedures should be unannounced, changed from prior years, or performed at unpredictable times.

Other basic or required audit procedures

3.12 A number of specific further audit procedures may be required (regardless of the assessed risks) to comply with the SAs and local requirements. Examples might include attending the inventory count, external confirmations, and subsequent events.

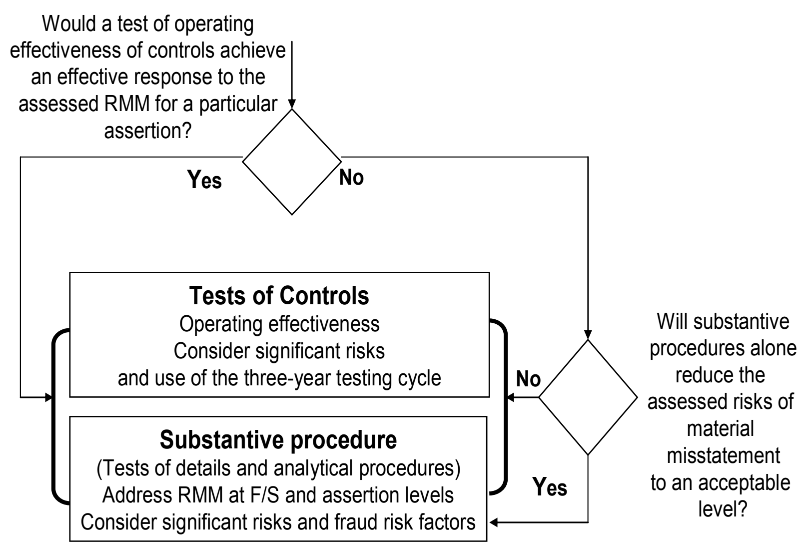
Design of Audit Procedures

3.13 The auditor can respond to assessed risks through the design of further audit procedures. These procedures usually involve elements such as inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures. There are three major categories:

- Risk assessment procedures;
- Tests of the operating effectiveness of internal control; and
- Substantive procedures. This includes tests of detail and substantive analytical procedures.

3.14 An appropriate response to assessed risks may contain a combination of procedures such as tests of controls and substantive procedures.

3.15 The following outlines some of the considerations in developing the appropriate response.



Factors to Consider in Designing the Nature of Procedures	
Nature of Assertions	Certain audit procedures may: · Be more appropriate for addressing some assertions than others. Evidence for completeness of sales may best be obtained through a test of controls, whereas evidence to support the valuation of inventory will probably be obtained with substantive procedures; and · Provide more reliable evidence for an assertion. A confirmation of receivables to determine existence may provide better evidence than simply examining invoices or performing some analytical procedures.
Assessed Level of Risk	The higher the risk of misstatement, the more reliable and relevant is the audit evidence required. This may affect both the types and the combination of different types of audit procedures to be performed. For example, to ensure the existence of high value inventory, a physical inspection may be performed in addition to examining the supporting documents.
The Reasons for Risk	The underlying reasons for the risk should be considered in the design of both tests of controls and substantive procedures. This will include the characteristics of the financial statement area (inherent risks) and the internal control in place (control risk). If the assessed risk is low because of good internal control, tests of controls may reduce the need for or extent of substantive procedures.
Source of Information	If non-financial information produced by the entity's information system is used in performing audit procedures, evidence should be obtained about its accuracy and completeness. For example, the number of rental units in a high-rise apartment could be multiplied by the monthly apartment rental to compare with the total revenues recorded.

Factors to Consider in Designing the Nature of Procedures	
Dual Purpose Tests	Where efficient, a test of internal control could be performed concurrently with a test of details on the same transaction. An invoice could be examined for approval (tests of controls) and to substantiate the transaction (tests of detail). If the test of details reveals a misstatement not caught by the internal control system, it might be indicative of a material weakness in internal control. Such weaknesses should be communicated to management and to those charged with governance, and the need for additional audit procedures considered. This will include updating the risk assessment and developing an appropriate audit response.

Timing of Procedures

3.16 Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

Before or at the Period End?

3.17 In most instances (particularly with small entities), audit procedures will be carried out at the period end and later. In addition, the higher the risks of material misstatement, the more likely it would be for substantive procedures to be performed nearer to, or after, the period-end.

3.18 In some situations though, there can be some advantages to performing audit procedures before the period end. For example:

- Helping to identify significant matters at an early stage. This provides time for the issues to be addressed and further audit procedures to be performed;
- Balancing the audit firm's workload by shifting some busy season procedures to a period when there is more time; and
- Performing procedures unannounced or at unpredictable times.

3.19 The following outlines the factors to consider when determining whether to perform procedures at an interim date.

	Factors to Consider
Should Audit Procedures be Performed Before the Period End?	· How good is the overall control environment? Performing a roll forward between an interim date and the period end is unlikely to be effective if the general control environment is poor. · How good are the specific controls over the account balance or class of transactions being considered? · Is the required evidence available to perform the test? Electronic files may subsequently be overwritten or procedures to be observed may occur only at certain times. · Would a procedure before the period end address the nature and substance of the risk involved? · Would the interim procedure address the period or date to which the audit evidence relates? · How much additional evidence will be required for the remaining period between the date of procedure and period end?

After Period End

3.20 Certain audit procedures can be performed only at, or after, the period-end. This would include cutoff procedures (where there is minimal reliance on internal control), period-end adjustments, and subsequent events.

Extent of Procedures

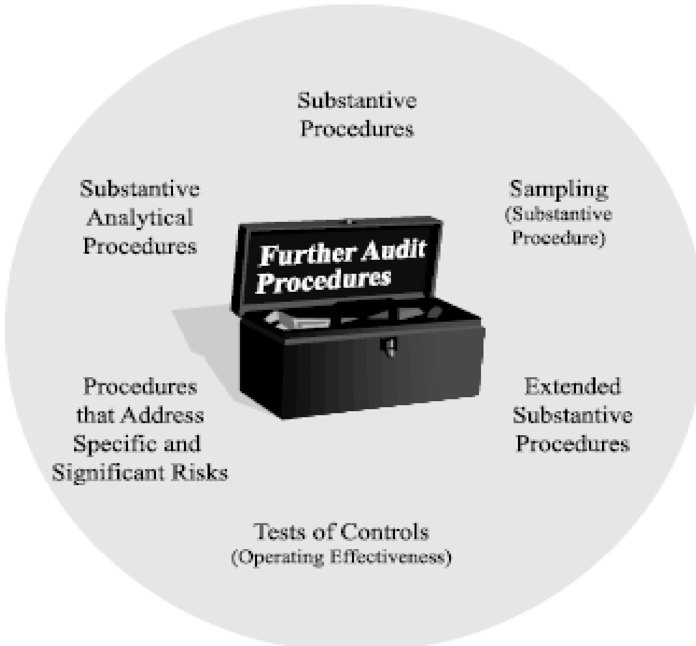
3.21 Extent relates to the quantity (sample size) of a specific audit procedure to be performed. The general rule is that as the risks of material misstatement increase, so should the sample size. However, this will only be effective if the procedure is relevant to the assessed risk.

The Audit Toolbox

3.22 As stated earlier, the objective of the detailed audit plan is to respond appropriately to the assessed risks and thereby reduce the audit risk to an acceptably low level.

3.23 The most effective approach would be to consider each assessed risk and then design an appropriate audit response in the form of further audit procedures. What is not appropriate is to use a standard ("one size fits all") audit program that may address each assertion, but has not been tailored in any way to address the assessed risks.

3.24 In developing the detailed plan, there are a number of different types of procedures that can be considered. An effective audit program will be based on an appropriate mix of procedures that collectively reduce audit risk to an acceptably low level. For the purposes of this Guide, the different types of audit procedures available to the auditor have been categorized as illustrated below.



Substantive Procedures

3.25 These include those procedures that would always be performed regardless of the risks of material misstatement (RMM) identified. Where the RMM is very low, these procedures alone might be sufficient for a specific area or assertion. Where the RMM is high, these basic procedures should be expanded in response to the assessed risks. A typical example would be obtaining a list of the items that make up the period-end balance, comparing this year's balance to that of last year, and performing some cut-off procedures.

Substantive Sampling

3.26 Where a basic procedure (such as confirmation of accounts receivable balances selected by a judgmental sample) is not sufficient to reduce audit risk to an acceptable level, additional confirmations may be selected using statistical sampling techniques.

Extended Substantive Procedures

3.27 These are basic substantive procedures that have been extended or tailored to address an assessed risk such as management override. For example, a basic substantive procedure would include confirming selected accounts receivable balances. Under the basic procedure, the confirmations obtained would be compared to the account balances. An extended procedure designed to address fraud risk would go a step further to include further work such as checking the telephone directory to establish that the company actually exists at the address provided.

Tests of Controls

3.28 Based on the understanding of internal control and the walk-through procedures, certain key controls may be identified (controls that address more than one assertion) that are expected to operate effectively. Testing of these controls may be the most effective audit procedure and will reduce the extent of other substantive procedures required.

3.29 The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

3.30 In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

3.31 In designing and performing tests of controls, the auditor shall:

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

   (i) How the controls were applied at relevant times during the period under audit;

   (ii) The consistency with which they were applied; and

   (iii) By whom or by what means they were applied.

(b) Determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

3.32 The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs below, in order to provide an appropriate basis for the auditor's intended reliance.

Purpose

3.33 Tests of controls are tests designed to obtain audit evidence about the operating effectiveness of controls. Controls can prevent material misstatements at the assertion level from occurring altogether, or detect and then correct them after they occurred. The controls selected for testing would be those that provide necessary audit evidence for a relevant assertion.

Consider Point

3.34 A walk-through procedure to determine whether a control has been implemented is not a test of control. It is a risk assessment procedure, the results of which may determine whether tests of controls would be useful and, if so, how they would be designed.

Consideration of test of controls

3.35 Tests of controls are considered by the auditor when:

- The risk assessment is based on an expectation that internal control operates effectively; or
- Substantive procedures alone will not provide sufficient appropriate audit evidence at the assertion level. This might apply where sales are made over the Internet and no documentation of transactions is produced or maintained, other than through the IT system.

3.36 Tests of controls are designed to obtain audit evidence about:

- How internal control procedures were applied throughout or at relevant times during the period under audit. If substantially different controls were used at different times during the period, each control system should be considered separately;
- The consistency with which internal control procedures were applied; and
- By whom or by what means controls were applied.

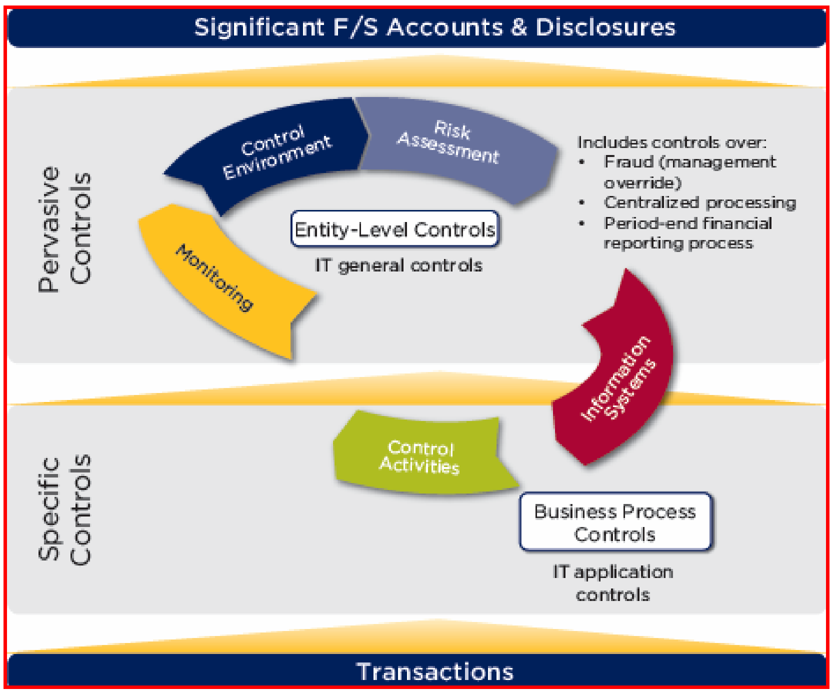
Consider Point

3.37 When auditing smaller entities, auditors often plan to perform substantive procedures on the assumption that tests of existing control activities would not be practical due to limited segregation of duties, etc. Before jumping to that conclusion, consider:

- The strength of the control environment and other elements of internal control;
- Existence of control activities over assertions where it would be more efficient to gain evidence through tests of controls; and
- Assertions where substantive procedures alone will not reduce the risks of material misstatement to an acceptably low level. For instance, this may be the case for the completeness of revenues.

Designing Tests of Controls

3.38 Tests of controls are used to gain evidence about the operating effectiveness of controls included in any of the five elements of internal control. See the exhibit below and on each of the five internal control elements.



3.39 Specific controls (such as control activities) directly address the prevention or detection and correction of misstatements, whereas pervasive controls provide the foundation for the specific controls and influence their operation.

3.40 In smaller entities, some pervasive controls (such as the control environment) may also serve to address specific risks of misstatement for a relevant assertion (for example, where senior management is directly involved in supervising and approving day-to-day transactions). In this case, if the pervasive controls were tested and found to operate effectively, there would be no need to test other controls (such as control activities) related to the particular risks involved.

> ***Consider Point***
>
> 3.41 Domination of management by a single individual does not mean that internal control is weak or does not exist. In fact, the involvement of a competent owner-manager in the detailed day-to-day operations would be an important control environment strength. The opportunity for management override of internal control still exists, but can be reduced to some extent (in virtually any size of entity) by implementing some simple anti-fraud controls.

3.42 In other cases, the link between pervasive and specific controls may be more direct. For example, some monitoring controls may identify control breakdowns in specific (business process) controls. If the auditor tested these monitoring controls for effectiveness, the need for testing more specific controls might be reduced (but not eliminated).

3.43 Tests of pervasive controls (often referred to as entity-level and general IT controls) tend to be more subjective (such as evaluating the commitment to integrity or competence) and therefore more difficult to document than specific internal control at the business process level (such as checking to see if a payment was authorized). As a result, the testing of entity-level and IT general controls are often documented with memorandums to the file explaining the approach taken and the action steps (for example, staff interviews, assessments, review of employee files, etc.), along with supporting evidence.

3.44 This approach is illustrated in the following example.

Testing Entity-Level Control

Control Component = Control Environment

Risk Addressed No emphasis is placed on need for integrity and ethical values.

Controls Identified Management requires all new employees to sign a form stating their agreement with the firm's fundamental values and understanding of the consequences for non-compliance.

Control Design Read the form to be signed by employees and ensure it does address integrity and ethical values.

Control Implementation Review one employee file to ensure there is a signed form and consider what evidence exists (such as discipline) that employees actually practice the values. This could be based on a short interview with an employee.

Test of Control Effectiveness Select a sample of employee files and ensure there are agreement forms on file and they are signed by the employee. This could be supplemented by asking some employees what are the entity values.

Documentation Provide details of the employee files selected and any interview notes along with the conclusions reached.

3.45 Some key factors for the auditor to consider in designing tests of controls are listed below.

Address - Description

What Risk of Material Misstatement and Assertion is being Addressed - Identify the risk of material misstatement and the related assertion that would be addressed by performing tests of controls. Then consider whether audit evidence about the relevant assertion can best be obtained by performing tests of controls or through substantive procedures.

Reliability of the Controls - As a general rule, it is not worth testing controls that may prove to be unreliable. This is because the small sample sizes commonly used for testing controls are based on finding no exceptions.

3.46 If any of the following factors are significant, it may be more effective to perform substantive procedures (if possible):

- Any history of errors?
- Any changes in the volume or nature of transactions?
- Are the underlying entity-level and general IT controls weak?
- Can controls be (or have been) circumvented by management?
- Frequency at which the control operates? (e.g., daily, weekly or monthly?)
- Any changes in personnel or competence of people performing the control?
- Is there a significant manual element in the control that could be prone to human error?
- Complexity of operation and major judgments involved with its operation?

3.47 *Existence of Indirect Controls*: Does control depend on the effective operation of other controls? This dependency or inter-relationship could include non-financial information produced by a separate process, the treatment of exceptions and management's periodic reviews of reports.

3.48 *Nature of Test to Meet Objectives:* Tests of control usually involve a combination of the following:

- Inquiries of appropriate personnel;
- Inspection of relevant documentation;
- Observation of the company's operations; and
- Re-performance of the application of the control.

3.49 Note that inquiry alone would not be sufficient evidence to support a conclusion about the effectiveness of a control. For example, to test the operating effectiveness of internal control over cash receipts, the auditor might observe the procedures for opening the mail and processing cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor would supplement the observation with inquiries of the entity's personnel and inspection of documentation about the operation of such internal control at other times.

Consider Point

3.50 Determine what constitutes a control deviation.

When designing a test of control, spend time to define exactly what constitutes an error or exception to the test. This step will save time spent by audit staff in determining whether a seemingly minor exception (such as an incorrect telephone number) is, in fact, a control deviation.

Automated Controls

3.51 There may be some instances where control activities are performed by a computer and supporting documentation does not exist. In these situations, the auditor may have to re-perform some controls to ensure the software application controls are working as designed.

3.52 Another approach is to use computer assisted audit techniques (CAATs). One example of a CAAT is a software package that can import an entity's data file (such as sales or payables), which can then be tested. Such programs can analyze client data to provide the audit evidence needed. In addition, they provide the potential to perform much more extensive testing of electronic transactions and account files. Some possible uses of CAATs are outlined below.

Use of CAATs

3.53 Typical Types of Procedures

- Select sample transactions from electronic files.
- Sort transactions with specific characteristics.
- Extract records based on specified criteria.
- Test an entire population instead of a sample.

- Find gaps and duplicates (numeric, text and date).
- Add files and check extensions such as pricing.
- Stratify, summarize and age information.
- Match data across files.

Consider Point

3.54 Smaller entities often use off-the-shelf packaged accounting and other relevant software without modification. However, many software packages actually contain proven application controls that could be used by the entity to reduce the extent of errors and possibly deter fraud. Auditors might want to ask their clients whether these controls are being used and, if not, whether there would be value to using them.

Timing of Tests of Controls

3.55 The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs below, in order to provide an appropriate basis for the auditor's intended reliance.

3.56 If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period.

3.57 If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

3.58 Tests of controls may provide evidence of effective operation:

- At a particular point in time (i.e., a physical inventory count); or

- Over a period of time such as the period under audit.

3.59 When the tests of controls take place before the period end, the auditor would consider what additional evidence may be required to cover the remaining period. This evidence may be obtained by extending the tests to cover the remaining period or testing the entity's monitoring of internal control.

Factors to Consider

3.60 Gap between the Tests of Controls and Period End

- Significance of assessed risks of material misstatement at the assertion level.
- Specific controls that were tested during the interim period.
- Degree to which audit evidence about the operating effectiveness of those controls was obtained.
- Length of the remaining period.
- Extent to which the auditor intends to reduce further substantive procedures based on the reliance on internal control.
- The control environment.
- Any significant changes in internal control, including changes in the information system, processes and personnel that occurred subsequent to the interim period.

Consider Point

3.61 Where efficient, consider performing tests on the operating effectiveness of internal controls at the same time as evaluating the design and implementation of these controls.

Using Audit Evidence Obtained in Previous Audits

3.62 In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

(a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

(b) The risks arising from the characteristics of the control, including whether it is manual or automated;

(c) The effectiveness of general IT-controls;

(d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

(e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

(f) The risks of material misstatement and the extent of reliance on the control.

3.63 If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit.

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

3.64 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.

Rotational Testing of Controls

3.65 Assuming internal control has not changed since the controls were last tested, the tests of operating effectiveness may only need to be performed (with certain exceptions such as outlined below) once every third audit. The actual period of reliance will be based on professional judgment but cannot exceed two years.

3.66 When there are a number of controls where evidence could be used from prior audits, the reliance should be staggered so that some testing of internal control is performed during each audit. Testing at least a few controls each period also provides collateral evidence about the continuing effectiveness of the control environment.

3.67 Before audit evidence obtained in prior audits can be used, the continuing relevance of such evidence needs to be established each period. This will include confirming the understanding of those specific controls through:

- Inquiry of management and others; and
- Observation or inspection (walkthroughs) of the internal control.

3.68 Reliance on evidence obtained in previous audits would not normally be applicable in the following situations:

Reliance on Prior Years' Audit Evidence

3.69 Use of control testing performed in prior years is not permitted when:

- Reliance is required to mitigate a "significant risk";
- Internal control has changed;
- A weak control environment exists;
- The ongoing monitoring of internal control is poor;
- There is a significant manual element to the operation of relevant controls;
- Personnel changes have occurred that significantly affect the application of the control;
- Changing circumstances indicate the need for changes in the operation of the control; and/or
- There are weak or ineffective general IT controls.

3.70 In general, the higher the risks of material misstatement or the greater the reliance placed on internal control, the shorter the time period should be between tests of controls.

Procedures that address specific and significant risks

3.71 These audit procedures would respond directly to a specific assessed risk. This would include audit procedures that respond directly to significant risks identified.

Substantive analytical procedures

3.72 There are substantive analytical procedures that could be used to predict the total of a transaction stream such as sales.

Documenting the Audit Plan

3.73 When the detailed plan has been determined, the results can be documented in the form of an audit program that outlines the nature and extent of procedures and the assertion(s) being addressed. Space can then be provided to record details about who performed each step and the findings is illustrated below.

3.74 A typical audit program (excluding the details of each specific audit step) might look as follows.

Note: This illustration includes all types of procedures, whereas there may be just one or two types of procedures required for a particular account balance or class of transactions.

Receivables – Audit Procedures

BASIC PROCRDURES

Analytical Procedures…
Balance listing…
Allowance for doubtful accounts, cut-off, reconciliations etc.,
Accounting policies

SAMPLING (i.e. confirmation of balances, etc.)

TESTS OF CONTROLS ON SALES

SUBSTANTIVE ANALYTICAL PROCEDURES

EXTENDED SUBSTANTIVE PROCEDURES

Accounts receivable confirmation – fraud risk…

SPECIFIC PROCEDURES TO ADDRESS SPECIFIC/ SIGNIFICANT RISKS

FINANCIAL STAEMENT PRESENTATION AND DISCLOSURE

Assertions addressed	**Work completed by (Initials)**	**W/P ref.**	**Comments**
CEA			
C			
VAE			
A			
E			
A			
EC			
EA			
EV			
CEAV			

Audit Conclusions

a) These procedures (including tests of controls, where applicable) have been tailored (as necessary) to respond to the assessed risks of material misstatement at the financial statement and assertion level.

b) The risks of material misstatement in the accounts receivable balance have been reduced to an acceptable level.

c) All relevant assertions have been addressed.

Prepared by
Reviewed by

Date	**Initials**

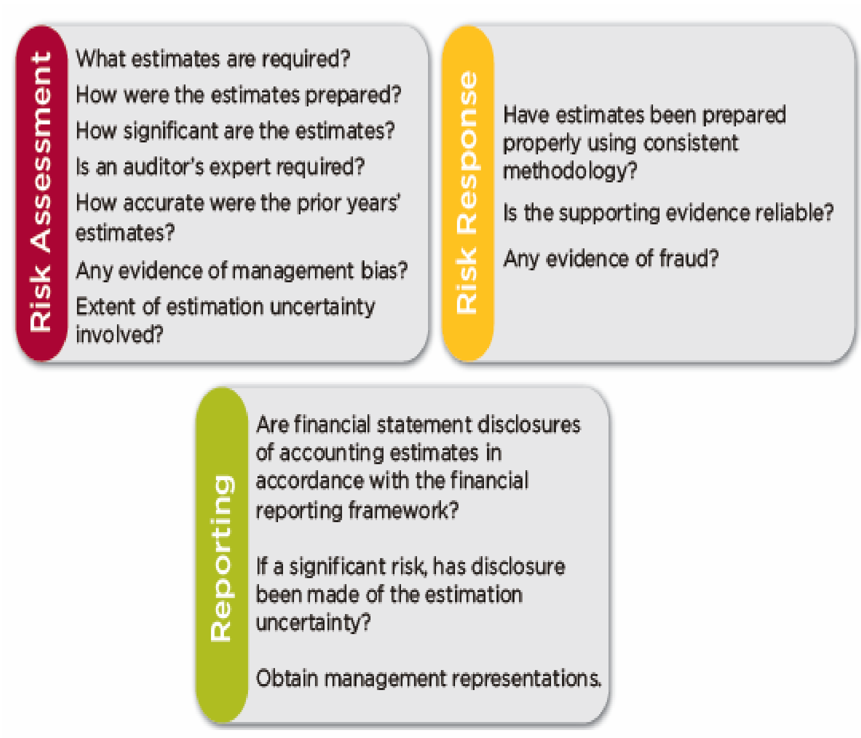
Communication of the Plan

3.75 An ongoing dialogue with management and those charged with governance can play an important role in the audit planning process. Communicating various aspects of the overall audit strategy may also be helpful to those charged with governance in understanding the role of the auditor and for discharging their responsibilities.

Accounting Estimates

3.76 The section contains audit procedures relating to the audit of accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

Exhibit



Overview

3.77 The objective when auditing the accounting estimates is to obtain sufficient appropriate audit evidence about whether:

- Accounting estimates, including fair value accounting estimates in the financial statements, whether recognized or disclosed, are reasonable; and
- Related disclosures in the financial statements are adequate.

3.78 Some financial statement items cannot be measured precisely and therefore have to be estimated. Such accounting estimates range from the straightforward (such as net realizable values for inventory and accounts receivable) to the more complex (such as calculating revenues to be recorded from long-term contracts and future liabilities on product warranties and guarantees). Estimates can often involve considerable analyses of historical and current data and the forecasting of future events such as sales transactions.

3.79 The measurement of accounting estimates may vary based on the requirements of the financial reporting framework and the financial item involved. For example, the measurement objective of an estimate may be to:

- Forecast the outcome of one or more transactions, events or conditions that gave rise to the accounting estimate; or
- Determine the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. This would include fair value measurements.

3.80 The degree of misstatement in an accounting estimate is more difficult to assess than other types of misstatement. This difficulty results from the following:

- The complexity and subjectivity involved in preparing estimates;
- The availability and reliability of data;
- The nature and extent of assumptions required; and
- The degree of uncertainty of future events.

3.81 A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Risk Assessment

3.82 For smaller entities, the amount of work involved in preparing estimates will be less complex as their business activities are often limited and transactions are less complex. Often a single person, such as the owner-manager, will identify the need for accounting estimates and the auditor may focus the inquiries accordingly.

3.83 *How is the Need for an Estimate Identified?* This could result from the financial reporting framework being used or from transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In addition, the auditor would make inquiries of management about changes in circumstances that give rise to new, or the need to revise existing, accounting estimates.

3.84 *Management's Process for Making Estimates:* Review and evaluate management's estimation processes including the development of the underlying assumptions, reliability of data used and any internal approval or review process. Where applicable, this could also include the use of an expert.

3.85 *Outcomes of Estimates Prepared in Previous Periods:* Review the outcome of the previous period's estimates and understand the reasons for differences between prior period estimates and the actual amounts. This will help to understand:

- Effectiveness (or not) of management's estimation process;
- Existence of any possible management bias;
- Existence of pertinent audit evidence; and
- Extent of estimation uncertainty involved, which may be required to be disclosed in the financial statements.

3.86 *Extent of Estimation Uncertainty Involved:* Consider the following:

- Extent of management's judgement involved;
- Sensitivity to changes in assumptions;
- Existence of recognized measurement techniques that mitigate the uncertainty;
- Length of the forecast period and relevance of data used;
- Availability of reliable data from external sources;
- Extent estimate is based on observable or unobservable inputs; and
- Susceptibility to bias.

3.87 *Significance of the Estimates:* In assessing the risks of material misstatement, consider:

- Matters addressed above in this table;
- Actual or expected magnitude of the estimate; and
- Whether the estimate creates a significant risk.

Responses to Assessed Risks

3.88 In smaller entities, there is likely to be active management involvement in the financial reporting process, which includes accounting estimate preparation. As a result, controls over the estimating process may not exist, or if they do exist, may operate informally. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature.

3.89 *Have Estimates been Prepared Appropriately?* Do the estimates comply:

- With the applicable financial reporting framework?
- Were methods used for making the estimates appropriate and applied consistently?
- How reliable is the Supporting Evidence?
- Review events subsequent to the period end to ensure they support management's estimates.
- Test the information, controls (if any), methods and assumptions used.
- Establish an independent point estimate or zone of reasonableness. Based on available evidence and discussions with management, develop an independent point estimate or zone of reasonableness for comparison with the entity's estimate. The amount by which management's estimate differs from the point estimate or falls outside the zone of reasonableness would be considered as a misstatement.

Possible Management Bias

- Consider the cumulative effect of bias in the preparation of management's accounting estimates. This could occur where estimates consistently lie at one boundary of the zone of reasonableness or move from one boundary to the other in successive periods.

3.90 Where the estimate is complex or involves specialized techniques, the auditor may determine it is necessary to use the work of an expert.

3.91 Where insufficient appropriate evidence is available or the evidence refutes management's estimates, the auditor would discuss the findings with management and consider the need to change the risk assessment and perform further audit procedures.

Reporting

3.92 The final step is to determine whether the disclosures in the financial statements about the estimates:

- Are in accordance with the requirements of the applicable financial reporting framework; and
- Adequately disclose their estimation uncertainty, if they give rise to significant risks.

Written Representations

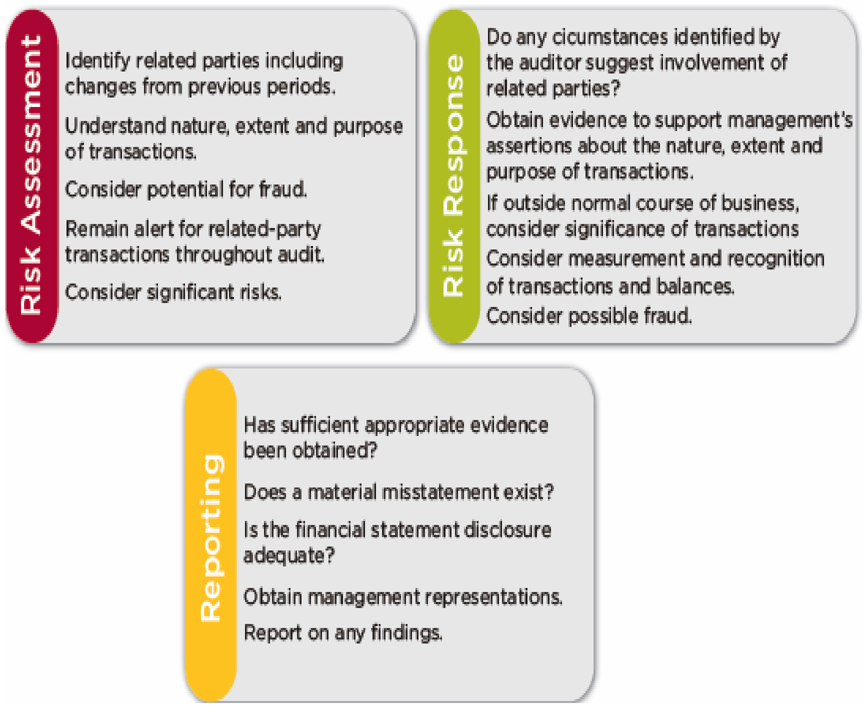
3.93 The auditor would obtain written representations from management regarding:

- The reasonableness of significant assumptions; and
- Whether the assumptions appropriately reflect management's intent and ability to carry out specific courses of action relevant to any fair value measurements or disclosures.

Related Parties

3.94 Audit procedures regarding related parties and transactions with such parties.

Exhibit



Overview

3.95 As related parties are not independent of each other, there may be higher risks of material misstatement in related-party transactions than transactions with unrelated parties. Consequently, financial reporting frameworks often contain accounting and disclosure requirements regarding related-party transactions. These disclosures are intended to provide financial statement users with an understanding of the nature of these transactions and the actual or potential effects.

3.96 Some of the potential risks with regard to related-party transactions are set out below.

Overly complex transactions: Related parties may operate through an extensive and complex range of relationships and structures.

Relationships and transactions not identified: The entity's information systems may be ineffective at identifying or summarizing transactions and outstanding balances between the entity and its related parties.

Not conducted in the normal course of business: Related-party transactions may not be conducted under normal market terms and conditions such as above, below fair values or even with no exchange of consideration at all.

3.97 Management is responsible for the identification and disclosure of related parties and transactions. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements. In smaller entities, these procedures are likely to be less sophisticated and informal.

3.98 The auditor is responsible to maintain alertness for related-party information when reviewing records or documents during the audit. This includes the inspection of certain key documents but does not require an extensive investigation of records and documents to specifically identify related parties.

Risk Assessment

3.99 To identify the risks of material misstatement associated with related-party relationships and transactions, the auditor would consider the matters set out below.

Address Existence/Nature/Impact of Related Parties and Transactions: Inquire about the identity of related parties, including changes from prior period.

- Understand controls (if any) that management has established to identify, authorize, approve account for and disclose related parties and transactions, including those outside the normal course of business.
- Determine nature of related-party relationships and extent of type and purpose of transactions.

Consider Possible Fraud: Discuss among the engagement team the susceptibility of financial statements to material misstatement due to fraud or error resulting from related-party relationships and transactions. If fraud risk factors are identified, an appropriate audit response would also be developed.

Remain Alert when Inspecting Records or Documents: Engagement team members should always remain alert to undisclosed related-party relationships or transactions when inspecting records or documents, including:

- Bank and legal confirmations;
- Minutes of meetings of shareholders and of those charged with governance; and
- Significant transactions outside the entity's normal course of business.

Always share information obtained about possible related parties with other team members.

Identify Significant Risks: Significant related-party transactions outside the normal course of business would normally give rise to significant risks.

Consider Point

3.100 In smaller entities, the identification of related-party transactions can often be difficult. If the client uses a standard software package to record transactions, consider obtaining an electronic copy of transactions and then importing them into an electronic spreadsheet. Using the sort features and configuring some selection criteria, the auditor can usually readily identify unusual patterns in customers / suppliers and high-value transactions.

Risk Response

3.101 In response to the identified risks of material misstatement associated with related party relationships and transactions, the auditor would consider the matters set out below.

When Related Parties are Identified by the Auditor

- Determine whether there are underlying circumstances and confirm their existence;
- Promptly communicate this information to engagement team;
- Request management to identify all related-party transactions;
- If a related party was not previously identified, ask why. Consider:
  - o Failure of any related-party identification controls, and
  - o Fraud (non-disclosure by management appears intentional);
- Reconsider the risk that other undisclosed related parties or significant related party transactions may exist and perform further audit procedures as necessary; and
- Perform appropriate substantive audit procedures.

Transactions Outside Normal Course of Business

- Inspect underlying contracts or agreements, if any, and evaluate whether:
  - o Rationale suggests possible fraudulent financial reporting or concealment of misappropriated assets,
  - o Terms are consistent with management's explanations, and
  - o Transactions are accounted for and disclosed in accordance with the applicable financial reporting framework; and
- Ensure transactions have been appropriately authorized and approved.

Management's Assertions: Obtain sufficient appropriate audit evidence about management's assertions about the nature and extent of related party transactions.

Reporting

3.102 In forming an opinion on the financial statements, the auditor would consider the following matters with regards to related parties and transactions.

Determine if the Audit Opinion Needs to be Modified: Modify the auditor's report if:

- It is not possible to obtain sufficient appropriate audit evidence concerning related parties and transactions; or
- Management's disclosure in the financial statements (as required by the financial reporting framework) is not considered adequate.
- Obtain a Management Representation: Obtain written representations from management (and those charged with governance) that:
- All related parties and transactions have been disclosed; and
- Such relationships and transactions have been appropriately accounted for and disclosed in the financial statements.

Document and Report

- Document the names of the identified related parties and the nature of the related-party relationships; and
- Communicate with those charged with governance any significant matters arising during the audit in connection with related parties.

Subsequent Events

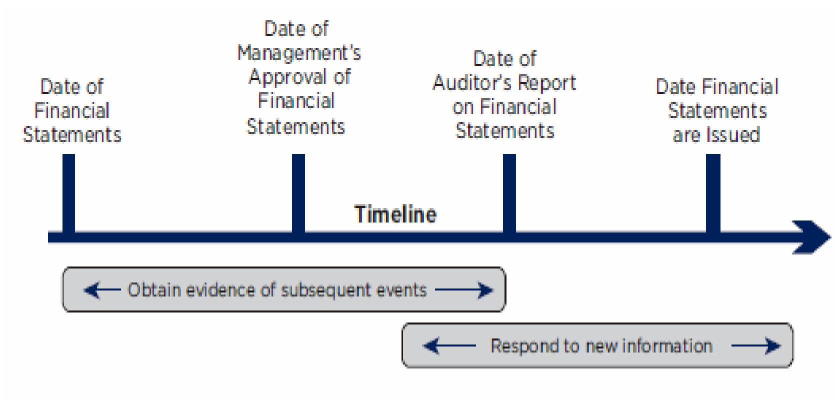
3.103 The section contains auditor's responsibility regarding subsequent events.

Overview

3.104 This standard provides guidance on the auditor's responsibility regarding subsequent events.

3.105 Subsequent events occur after the date of the financial statements (the period-end date). Other key dates in the preparation and release of financial statements are outlined in the exhibit below.

Exhibit



3.106 In determining the existence of subsequent events and assessing their impact, the auditor would carry out the steps set out below.

3.107 *Do Subsequent Events Exist?* Perform audit procedures to identify any subsequent events that would require adjustment of, or disclosure in, the financial statements. This would include:

- Understanding management procedures (if any) to identify subsequent events;
- Making inquiries of management (and those charged with governance) about subsequent events such as:

- o New commitments, borrowings or guarantees,
- o Planned / actual acquisition / sale of assets,
- o Appropriation or destruction of assets,
- o Business acquisitions or divestitures,
- o Increases in capital or debt instruments,
- o Litigation, claims and contingencies,
- o Unusual accounting adjustments made or contemplated,
- o Validity of the going-concern assumption or other accounting policies,
- o Events that affect the measurement of estimates or provisions made in the financial statements, and
- o Events relevant to the recoverability of assets.

- Reading minutes, if any, of the meetings (management and those charged with governance) held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available; and
- Reading financial reports produced after the period end, if any.

Obtain a Management Representation: Request a written representation that all subsequent events have been adjusted or disclosed in the financial statements.

3.108 *An Event Occurs after Date of Auditor's Report but before Financial Statements are Issued*

- Discuss the matter with management (and those charged with governance).
- Determine whether the financial statements need amendment and, if so:

  - o Inquire how management intends to address the matter in the financial statements,
  - o Perform any further audit procedures required, and
  - o Issue a new auditor's report on the amended financial statements. This could also include dual dating of the report, restricted to the amendment or inclusion of an emphasis of matter paragraph

- Where management does not amend the financial statements, the auditor would issue a modified auditor's opinion.
- If the auditor's report has already been released, notify management (and those charged with governance) not to issue the financial statements or the auditor's report to third parties.
- If the financial statements are released despite the notification, take appropriate action (after consulting with legal counsel) to prevent reliance on the auditor's report.

3.109 *An Event Occurs after the Financial Statements are Issued*

- Discuss the matter with management (and those charged with governance).
- Determine whether the financial statements need amendment and, if so, inquire how management intends to address the matter in the financial statements.
- If management amends the financial statements:
  - o Extend the subsequent event audit procedures to the date of the new auditor's report unless the auditor's report is amended to include an additional date restricted to a particular amendment,
  - o Perform any further audit procedures required,
  - o Review management's actions to ensure anyone in receipt of the previously issued financial statements

and auditor's report thereon is informed of the situation,

  - o Provide a new auditor's report on the amended financial statements, and
  - o Issue a new or amended auditor's report that includes an "Emphasis of Matter" paragraph.

- If management does not take steps to ensure anyone in receipt of the previously issued financial statements is informed of the situation:
  - o Notify management (and those charged with governance) that the auditor will take appropriate action to seek to prevent reliance on the auditor's report.
- If, despite such notification, management (or those charged with governance) does not take the necessary steps, take appropriate action (such as consulting with legal counsel) to prevent reliance on the auditor's report.

Consider Point

3.110 It is in the interests of both the auditor and the client to complete the work necessary to issue the auditor's report on a timely basis. This will minimize the extent of work involved to identify, assess and possibly disclose subsequent events in the financial statements.

Amending Audit Reports

3.111 There are three methods of amending an audit report to address an amendment to the financial statements.

Dual Dating

3.112 Where the auditor's report is amended to include an additional date restricted to a particular amendment (that is, a subsequent event occurring after the date of the auditor's report), the original date of the auditor's report is retained. A new date is added to inform readers that the auditor's procedures subsequent to the original date were restricted to the subsequent amendment. Typical wording for an auditor's report originally dated September 15, 20xx and a Note Y where the audit work was completed on December 3, 20xx would be as follows:

- "September 15, 20xx except as to Note Y, which is as of December 3, 20xx."

Emphasis of Matter Paragraph

3.113 An Emphasis of Matter paragraph refers to a note in the financial statements that more extensively discusses the reason for the amendment to the previously issued financial statements and auditor's report.

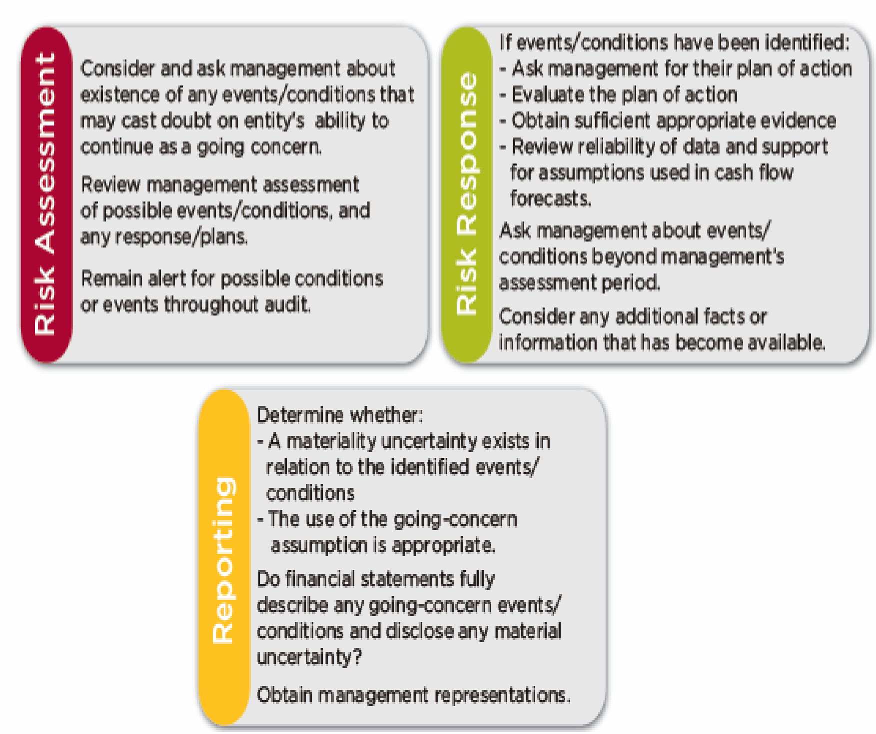
For example:

- "We draw attention to Note X to the financial statements, which describe the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Company. Our opinion is not qualified in respect of this matter."

Going Concern

3.114 The section contains auditor's responsibility with respect to the going-concern assumption and management's assessment of the entity's ability to continue as a going concern.

Exhibit



Overview

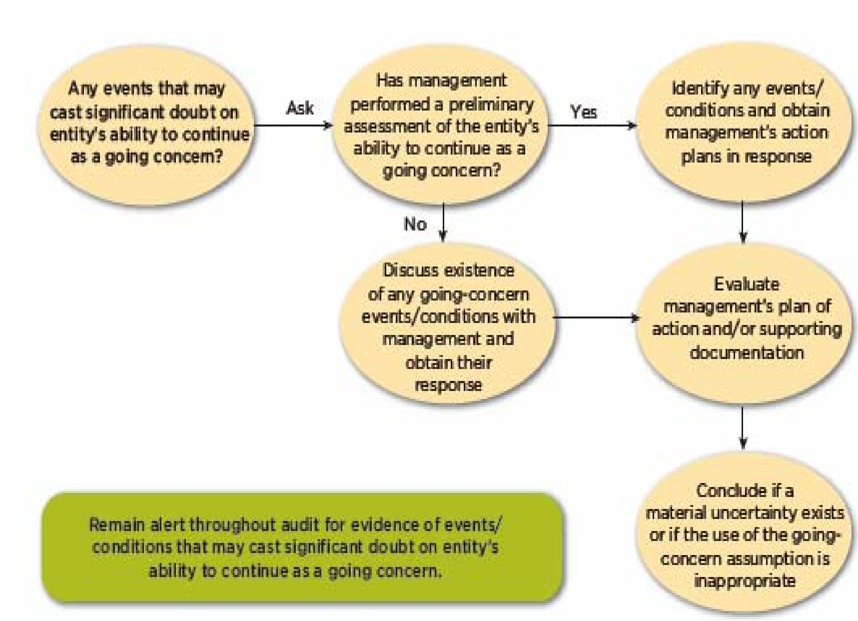
3.115 The going-concern assumption is a fundamental principle in the preparation of financial statements.

3.116 This standard provides guidance on the auditor's responsibility in the audit of financial statements with respect to the going-concern assumption and management's assessment of the entity's ability to continue as a going concern.

3.117 Under the going-concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or 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 the normal course of business.

Risk Assessment Procedures

3.118 The requirements can be summarized as set out below.



3.119 Examples of some events or conditions that, individually or collectively, may cast significant doubt about the going-concern assumption are set out below.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.

- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management's intentions to liquidate the entity or to cease operations.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments. Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.

- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes.

3.120 The significance of the above events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Evaluating Management's Assessment

Evaluating Management's Plans in Smaller Entities

3.121 Management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern. They may rely instead on their in-depth knowledge of the business and anticipated future prospects.

3.122 The auditor's typical evaluation procedures would include:

- Discussing medium and long-term financing with management;
- Corroborating management's intentions with the understanding of the entity obtained and documentary evidence;
- Satisfying the requirement for management to extend its assessment period to at least 12 months through discussion, inquiry and inspection by the auditor as to their feasibility or otherwise substantiated and the supporting documentation. For example, a prediction of future sales revenues could be supported by potential sales orders or sales contracts, which could be evaluated; and
- Inquiring if management has knowledge of events / conditions beyond the period of management's

assessment that would cast significant doubt on the entity's ability to continue as a going concern.

3.123 Where a small entity is largely financed by a loan or loan guarantees from the owner-manager (or other related parties such as family members), a withdrawal or major alteration in the terms of these funds could cast significant doubt on the entity's ability to continue as a going concern.

3.124 *Documentary Evidence Available:* Document:

- Terms of any loans provided to the entity;
- Details of subordinated loans to a third party such as the bank; and
- Details of financing by third parties based on guarantees or personal assets pledged as collateral.

3.125 *Is Additional Support Available?* Evaluate the ability of the owner-manager or other related parties to:

- Provide the necessary additional support such as loans or guarantees; and
- Meet the obligations under the support arrangements.

3.126 *Written Confirmations*: Request written confirmation of the:

- Terms and conditions of the financial support being provided; and
- The owner-manager's intentions or understanding in respect of the support being provided.

Risk Response — When Events are Identified

3.127 Where the auditor identifies going-concern events / conditions, the next step is to perform additional procedures (including consideration of mitigating factors) to determine whether or not a material uncertainty exists.

Material Uncertainty

3.128 A material (significant) uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is considered necessary in the financial statements.

3.129 Management's action plans to address going-concern issues typically include one or more of the following strategies:

- Liquidating assets;
- Borrowing money or restructuring debt;
- Reducing or delaying expenditures;
- Restructuring operations, including products and services;
- Seeking a merger or acquisition; or
- Increasing capital.

3.130 *Asking for Management's Assessment and Plan:* If not already provided, request management to make an assessment of the entity's ability to continue as a going concern.

Evaluating Management's Plans of Action: Evaluate management's future actions to address the going-concern assessment. Address:

- Will outcome of plans improve the situation?
- Are the plans feasible in the circumstances?
- How reliable are the profit / cash flow forecasts and what support is there for the assumptions used?
- Identifying, discussing and obtaining evidence for other factors that may affect the entity's ability to continue as going concern such as:
    - Poor recent operating results,

- Breaches in terms of debentures and loan agreements,
- References in meeting minutes to financing difficulties,
- Existence of litigation / claims and estimates of financial implications,
- Existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties,
- Financial ability of related and third parties to provide additional funds or loan guarantees,
- Other subsequent events, and
- Indicators of fraud such as management override, fictitious transactions or concealment of material facts.

- Continued existence, terms and adequacy of borrowing facilities.
- Reports on regulatory actions.
- Adequacy of support for any planned disposals of assets.

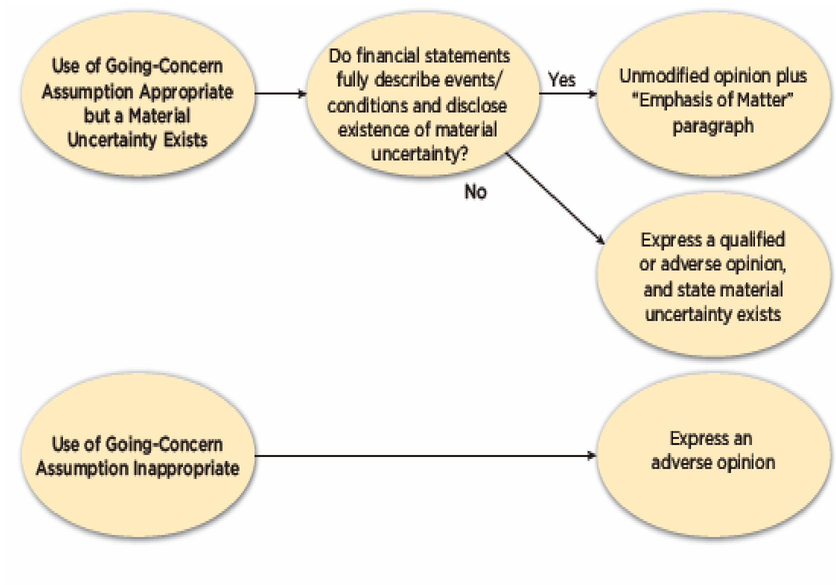
3.131 Also consider the impact of any additional facts or information since the date management made its assessment and plans.

Obtaining Written Confirmations: Request written representations from management (and those charged with governance) regarding their plans for future action and feasibility.

Reporting

3.132 The final step is to determine the impact of identified events / conditions on the audit report and communicate the decision to management and those charged with governance, where applicable.

3.133 The following exhibit summarizes the requirements.



Part D
Appendices

Appendix 1
Examples

Example 1

Background

Based on the preliminary cut off procedures done, the auditors noted that the invoices are being raised without despatching goods, where the policy for recognising revenue is based on despatches before year end.

Analysis

Sales booked in the current year is overstated.

Assertions

Cut off Procedures not adhered for Revenue

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Sales, Account receivable

Audit Procedures

The following procedures may ensure correct recognition of sales in line with the accounting policy:

- While performing substantive procedures for revenue account balance, ensure verification of despatch slip like lorry receipt/ security register/airway bill etc.
- While observing inventory count, check for goods invoiced not despatched logged separately.
- Meet with the company's inventory chain manager, and obtain written responses to our inquiries regarding the validity of the selected invoices.

- Discuss the impact of exceptions of such items with the client.

Example 2

Background

During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders.

Analysis

In terms of percentage, about 40% of purchases were made without valid purchase orders and also few purchase orders were validated after the actual purchase. Also there was no reconciliation between the goods received and the goods ordered.

Assertions

Validity of purchases

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Purchases, Account Payable

Audit Procedures

The following procedures may address the validity of the account balance:

- Make a selection of the purchases, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.

- Review Vendor listing along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.

- Meet with the company's Purchase officer, and obtain responses to our inquiries regarding the purchases made without purchase orders.
- Discuss the summary of such issues with the client.

Example 3

Background

Based on the enquiry made to the management of a large manufacturing company about current changes to the ERP environment the auditors noted migration of accounting system live during the year.

Analysis

On a preliminary review of the ERP implementation, the opening balances were not fed in to the database properly. The auditors noted material differences in the opening balance fed in to the system as compared to the previous year audited figures.

Assertions

Validity of financial statements

Pervasive/Account Balance Level

Pervasive

Account Balance(s) affected

Balance sheet accounts

Audit Procedures

The following procedures may address the validity of the financial statements generated from the new ERP:

- Discuss and obtain responses to our inquiries regarding the validity of the financial statements which are generated by ERP.

- Review opening balances account balance wise and also analyze the impact of the same in the current financial statements.
- Use of CAAT (Computer Aided Auditing Technique) may be done for generating exception reports, and evaluate the built in checks say, approvals or reconciliation etc.
- Discuss the summary of the testing and exceptions noted with the client in charge.

Example 4

Background

The company is a distributor of high-tech IT equipments; it also involved in the services equipment selling of that involves sales of replacement parts as well as labour. Because of rapid technological development for some of the equipment and the necessity to have a stock of replacement parts in order to service all of the equipment, the obsolescence provision presents a problem each year. The issue is particularly sensitive because the inventory is a security for a significant loan (maximum loan set at 75 percent of the net inventory), and management has historically tended to understate the obsolescence provision.

Analysis

Because there is a history of valuation problems, there is a specific risk with respect to misstatement of the obsolescence provision.

Assertions

Valuation

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Inventory, Provision for obsolescence.

Audit Procedures

Develop an independent range of reasonable estimates and determine whether management's estimate falls within this range. The focused procedures might include :

- Review management's procedures to identify obsolete inventory, including identification of such items at the inventory count. Review compliance with these procedures, as well as noting items that appear obsolete but are not identified as obsolete by the client.
- Test market value of items noted as obsolete by the client (and by us at the inventory count). Compare to recorded costs in order to assess adequacy of provisions.
- Compare the prior year listing of obsolete items to the final inventory listings of the current year to determine that items written down have not been re-instated.
- Interview sales and service personnel to determine if significant lines or items have been discounted or have become obsolete or if excessive quantities are on hand.
- Review perpetual inventory records to determine if significant lines or items with low usage have been omitted from the obsolescence evaluation.
- Consider sales analyses and forecast trends in sales *Vis-a-Vis* quantities in inventory. Evaluate results, and review the same with management.

Example 5

Background

Based on the enquiry made to the management of a large construction company about significant claims and related adjustments to subcontracts signed during the year the following is noted :

"Because of economic problems and tough competition, it has become increasingly common for subcontractors to present cost tenders in order to get the contract, knowing that they will prepare additional claims for cost overrun "

Analysis

Because of the above and a high volume of subcontracts, there were many claims by subcontractors during the year. Consequently, there is a risk of misstatement of job costs and accruals recorded in the books at the end of the year with respect to subcontractors.

Assertions

Completeness and valuation of job costs and accruals related to claims for "cost overrun"

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Job costs and accruals for claims.

Audit Procedures

The following procedures (though do not address the job cost system audit as a whole) address only the completeness and valuation of the subcontractor claims:

- Make a selection of subcontractor claims; review correspondence relating to the subcontractors' claims and reconciliations of their accounts. Meet with the contract director and the relevant project director to discuss the claims and to evaluate the amounts claimed and completeness of amounts accrued.
- Review approved outstanding orders for which no invoices have been received. Follow up material amounts to ensure that the related goods and/or services have not been delivered or rendered prior to the year-end and that they are therefore valid exclusions from job cost accruals.

- Meet with the company's in-house legal advisors, and obtain written responses to our inquiries regarding the legal validity of the selected subcontract claims.
- The audit in charge should discuss the summary of such claims with the Chief Executive Officer.

Appendix 2

Case Study

A case study has been developed to accompany this Guide. The purpose of the case study is to illustrate how certain sections of the SAs can be applied in practice. The following provides background information about the fictional company, ABC furniture ltd.

Readers may note that this case study is purely illustrative. The data, analysis and commentary do not represent all of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise his professional judgment.

ABC Furniture Ltd

ABC Furniture ltd. is a family-owned furniture manufacturing company. It produces various kinds of wooden household furniture, both ready-made and custom built. ABC Furniture ltd has an excellent reputation for producing quality products.

The company has three major product lines *i.e.*, bedroom sets, dining room sets, and tables of all sorts. Standard pieces of furniture can also be customized for specific needs. Recently, the company supplied a very unique dining room set to a local celebrity and, as a result, received a lot of press coverage. Amid a lot of excitement (and concern) by family members, they recently set up a web page where people can buy furniture directly and pay through a credit card. During the last year, the company shipped custom orders as far as 900 kilometres away.

The manufacturing facility is located on an acre of land adjacent to owner Suraj Dephta's house. An addition on the west side of Suraj's home acts as ABC Furniture ltd. Major decisions are often made around the dining room table (which is the first table that Suraj and his father built together). He likes the symbolism of sharing a meal on the product that produces his family's money for food.

Industry Trends

The furniture industry is expanding due to:

A growing economy (more people can afford good furniture);

Availability of skilled labour;

Government policies that encourage business development; and

Local lumber mills that can now produce raw materials at a competitive rate.

Because of this growth, the furniture industry is attracting new players and there is some consolidation of smaller manufacturers by larger, more profitable manufacturers. Retailers are placing larger orders but only in exchange for lower prices. This demand is driving production in assembly-line style factories that have a few standard product lines. As a result, the market for traditional, handcrafted furniture, for which the region was known, is beginning to dwindle.

Governance

The company was started in 1952 by Suraj's father, Jeewan Dephta. Jeewan first made wooden spindles and banisters with one lathe in a small workshop next to the family home.

The company does not have a formal governance structure. Jeewan and Suraj prepare a business plan each year and then meet regularly (once a month) with a successful local businessman, Ravi Jain, to review their progress against the plan. They also pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results and provide advice on how to deal with any specific issues that have arisen.

Ravi's daughter, Parvin (a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin does offer some legal advice, but her true passion lies in marketing and promotion. It was Parvin's idea that Dephta Furniture should expand its boundaries and start selling their products on the Internet. She also pushed for expansion outside their local region and even to neighbouring countries. Although Jeewan is somewhat skeptical about expanding beyond local boundaries, Suraj sees this as an opportunity to expand the business and become more profitable.

Employees

ABC furniture ltd has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders when an order deadline exists. Some weeks there is no need for temporary workers, but at other times as many as three to seven temporary workers may be employed. A few of the temporary workers return regularly but because of low pay and lack of security, the turnover is quite high, a situation which makes training a high priority.

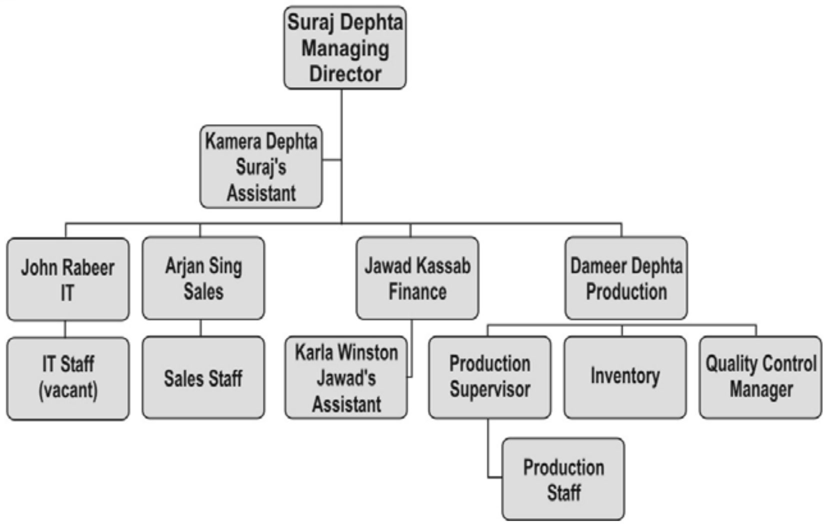
Suraj Dephta is the managing director. He oversees all aspects of the business with the help of his assistant, Kamera, who is his daughter-in-law.

Arjan Sing is in charge of sales and he is assisted by full-time sales people.

Dameer, Suraj's brother, looks after production, which includes ordering raw materials and managing the inventory. There are also a production supervisor and a person in charge of quality control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.

Jawad Kassab (a cousin of Suraj) is in charge of the finance function and John Rabeer is in charge of information technology (IT).

Organizational Chart



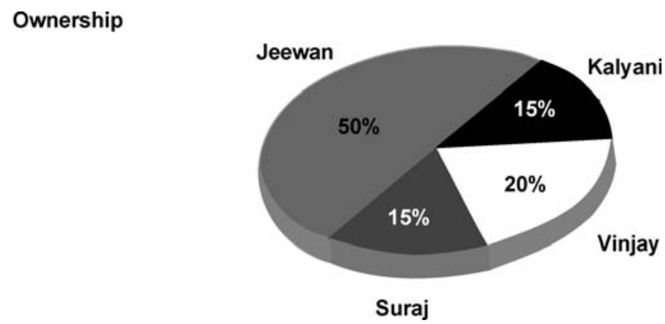
At present the production supervisor is also responsible for inventory. Most of the full-time employees live close by. They either walk or take the bus to work. During busy periods, Suraj provides accommodation for temporary workers in some old buildings on his land. He supplies his workers with lunch each day as a benefit and also so that they can spend the maximum time working at the factory.

Ownership

Jeewan is the principal shareholder with a 50% interest in the company. He has plans to start transferring the shares to his son, Suraj, as long as Suraj continues to manage the company full-time and the company remains profitable as a result. Suraj and his sister Kalyani both hold a 15% interest respectively.

The remaining 20% is held by a family friend, Vinjay Sharma. Vinjay is a wealthy investor who has provided much of the capital needed to grow the company. He also provided Dephta with a 100,000Є loan to finance some new equipment needed for the larger orders. The loan bears annual interest of 12% and is repayable over 10 years, commencing January 1, 2001. The debt would be convertible to equity in case the company ever default in repaying either the interest and/or the principal on the loan.

Last year, Vinjay (63 years of age) expressed disappointment that Dephta did not accept a larger manufacturer's very generous offer to buy the company. Jeewan had totally rejected the offer, stating that this was a family company and it was not for sale. Vinjay saw this as a missed opportunity for the family to make money.



Kalyani is a well-known singer and she travels extensively. She is not involved in the operations of the company and totally relies on her father and brother to look after her interests.

In June of each year, Jeewan organizes a more formal business meeting. The shareholders meet in the morning (primarily to review the financial statements) and, later in the afternoon, hold a party for all staff. Suraj uses this occasion to tell the staff how well the business is doing and what the plans are for the future.

Operations

The company started out manufacturing chairs, tables and spindles for railings and banisters, but has since expanded into making simple household furniture such as dressers, wardrobes and cabinets. ABC Furniture ltd has grown considerably through strategies such as :

- Providing quality products at fair prices to local customers;
- Accepting larger furniture orders from national retailers. These large orders come with a firm delivery deadline (there are major penalties for late delivery) and the profit margins are much tighter than those for custom-made furniture;

- Being the first company in the region to sell (limited products) over the Internet; and
- Manufacturing parts such as spindles and round table legs for other local furniture manufacturers. This has enabled the company to purchase expensive lathes and specialized tools that other companies cannot afford.

ABC Furniture Ltd. Dephta also sells scrap furniture and wood (pieces rejected in the quality control process) at the factory for cash only.

New initiatives being considered include :

- Exporting their furniture to neighbouring countries. ABC Furniture Ltd. recognizes that this will mean higher shipping costs, dealing with customs, foreign currency exchange risk and the potential for damage during transport. However, Parvin is very well connected. She knows many people in local government and thinks she can facilitate the extra paperwork involved.
- Re-designing some of its tables, chairs and cabinets so they can be assembled with screws, rather than relying on dove-tailing, glue and dowels. This will enable the company to sell and ship the furniture in parts for assembly later on.

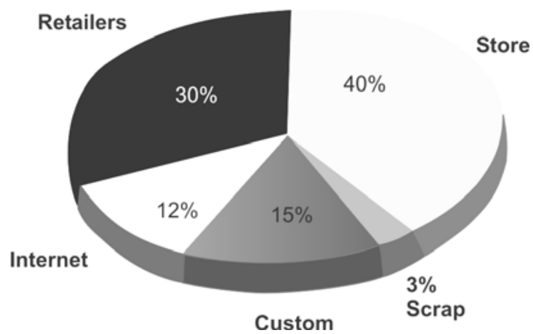
Sales

The sales breakdown is approximately:

- Standard furniture (catalogue) from sales that are negotiated in person at the store: 40%
- Sales to furniture retailers: 30%
- Internet sales: 12%
- Made-to-order (custom-built) furniture: 15%

- Scrap sales from factory: 3%

100%



Arjan Sing is a great dealmaker. He is very persistent when negotiating with customers and usually gets the sale, although the profit margins on these deals are sometimes very slim. Arjan loves to work hard, but he also likes to spend money. He recently bought a beautiful house overlooking the valley and a brand new Range Rover.

- **Notes on the sales system**
  - Sales contracts are prepared for retail and specialized orders. Deposits of 15% of the order are required on all custom orders, which are recorded as sales revenue when received. Two of the large retailers require ABC Furniture Ltd. to keep 30 days of inventory on hand so that orders can be shipped quickly to the stores when needed. These contracts also have provisions for inventory to be returned to ABC Furniture Ltd if it doesn't sell within a specified time period.
  - Sales orders are manually filled at the time of sale, except for furniture sold directly from the shop or other small items on hand. All orders over 500€, or where the sales price is below the minimum sales

price, must be approved by Arjan. Invoices are prepared when the items are shipped and sent to the customer.

- For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system, which automatically numbers after the each sale transaction and provides an order receipt if requested.
- A summary of the day's internet sales is downloaded from the website. Details of the items ordered are prepared and given to the production department. An invoice is prepared at the same time and recorded into revenue since the item has already been paid for by the customer's credit card. An invoice marked "paid in full" accompanies each Internet order that has been shipped.
- Arjan rarely performs credit checks on customers. He knows most of them. Customers used to pay cash upon delivery but credit is granted today to match the terms that their competitors are providing. As a result, ABC Furniture Ltd. requires a line of credit from the bank. Each year, the number of bad debts seems to be growing.
- At the end of each month, Suraj reviews the sales and accounts receivable listing. He ensures that there are no obvious mistakes and he personally calls every customer whose account is over due by 90 days.
- Each member of the sales staff (including Arjan) receives a commission of 15% on each sale in addition to a minimum base salary. To motivate the sales people, their base salary is well below the salaries of most of the other employees. The computer system tracks sales made by each sales person. Jawad prints off a report each month and

prepares a listing of commissions that will be paid on the following week's payroll. Either Suraj or Dameer reviews the listing of commissions and the sales to ensure the staff are paid the correct amount. Arjan receives by far the most sales commissions.

Information Technology

John oversees the company's computer system and IT operations. The system consists of six PCs and a server which is used for hosting the Internet site. The internal system is mainly used for email, order taking and accounting.

The son of one of Jawad's friends, Remal, helped with the basic set-up of the system and installation of the programs. John ensures the PCs are well-maintained, helps users with problems and runs weekly backups of the accounting system on an external hard drive that is kept in the safe next to the computer room. Firewall protection and password protection have all been added by John in the last two years. Last year, several PCs were stolen from the office. John realized that although the factory area was well secured, the offices and computer systems were vulnerable. Access to the offices is now better secured, the PCs are chained to desks, and the server is locked in a separate and specially cooled office.

Internet sales are managed by John with oversight by Dameer. They have an agreement with the bank to process the credit cards before any order is approved for shipping. They pay the bank 7% on each order processed. The application program for internet sales provides the details of each sale, including the customer's name, address, and the items ordered. Internet transactions are downloaded daily from the website and sales orders are prepared and forwarded to the production department.

Human Resources

All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. The company:

- Strives to hire the best talent it can find in the region and pays its full-time employees very competitive rates.
- Invests a considerable amount of time and money in training new employees. It holds training programs and has an informal mentoring process by which it requires newer employees to work with more experienced ones for a period of time.
- Posts many signs in the factory to remind workers about safety procedures. Last year, two temporary students were badly injured while using a lathe. This year, several new workers were disciplined for acting irresponsibly and endangering others.

Payroll

Employees are paid in cash at the beginning of each week. Jawad's assistant, Karla Winston, has a list of employees and calculates the payroll and deductions based on time card summaries that Dameer provides her. Suraj reviews payroll each Monday morning before instructing Karla to hand the envelopes to employees. All employees sign a list when they pick up their envelope. The company does not keep formal employee records.

Purchasing and Production

Dameer is responsible for purchasing and production. Because the inventory system is not very sophisticated, he tends to over-order some items, which often results in inventory sitting in the warehouse for long periods of time. This is considered better than under-ordering supplies, which results in production delays. He is also responsible for hiring enough workers to fulfill orders. Because estimating worker needs is not very scientific, many times there are either too many or too few workers.

- **Notes on the purchasing function**

o At least two quotes must be obtained before purchases over 5,000€ are approved. The exception is wood supplied by the local wood mill where Dephta has negotiated a five year exclusive supply contract.

- o The company prepares purchase orders for all inventory or capital purchases over 1,000€.
- o Dameer approves all new vendors and supplies the details to Jawad. Jawad then sets up the vendors in the system and enters details of invoices received.
- o ABC furniture ltd maintains 5,000€ in cash on the premises at all times, as a number of the smaller vendors like to be paid cash-on-delivery for raw materials.

Finance

Jawad studied accounting at university and is well versed in accounting and financial matters. When he joined ABC furniture ltd two years ago, he quickly introduced the "Sound Accounting" software package by Onion Corp. with its integrated accounts payable, accounts receivable, and capital assets modules.

- **Notes on the accounting function**
  - o At present, the company does not have a perpetual inventory system. Inventory is counted twice a year, once at year-end and once half way throughout the year. This ensures that profit margins on sales can be accurately calculated at least twice a year.
  - o Jawad has been frustrated by the lack of controls over inventory. He had suggested to Suraj that inventory be counted at least four times per year to ensure that margins are reviewed throughout the year. Suraj had overridden his recommendation, stating that it would be too disruptive to count inventory so often and it could cause the company to miss deadlines.
  - o Although ABC Furniture Ltd. has been profitable, the gross margins have been inconsistent. Jawad does not have an explanation as to why inventory costs are not tracked by product line. For example, one of the most time-consuming areas is making the intricate spindles for which ABC Furniture Ltd.

is known. The spindles are used in both the bedroom and dining room lines and are also sold to other manufacturers.

- o Jawad has also been pushing for costs to be tracked individually for custom pieces, including company overhead allocations. When he presented his calculations, Suraj could not believe that custom orders were losing money and asked Jawad to do the analysis again.
- o Suraj gets very annoyed at having to pay any form of income tax and usually pressures Jawad to ensure that accruals are "more than adequate".
- o The following income statement and balance sheet were prepared by management. Notes to the financial statements or a cash flow statement have not been included. Excerpts from significant accounting policies, terms and conditions for the loan payable, and details of related-party transactions have been included in the case study material used in the illustrations.

Overall Audit Strategy - ABC Furniture Limited for recurring audits:

Once the decision is made to continue with the audit of ABC Furniture Ltd, the next step is to develop and document an overall plan and strategy for conducting the engagement. This can be documented by a memo or by completing some form of planning checklist, as illustrated in the example below.

ABC Furniture Ltd. Overall Planning Memo

Scope

The scope of the audit has not changed this year and we are required to audit the financial statements in accordance with [insert applicable accounting framework] as at year end.

Changes

The company is beginning to expand beyond the local area. As the unit expands its sales to foreign countries and makes sales in foreign currencies, managing foreign exchange risk will become more important. Internet sales are also increasing, so unit's IT capabilities will be stretched. Changes in the following applicable financial reporting framework will also need to be reflected in financial statement preparation. This company is renowned for squeezing profit margins of suppliers in exchange for giving large orders. They also require suppliers to maintain additional inventories of some products for instant delivery as required.

Internal Control Environment

Our assessment of risk at the financial statements level is low (refer to W/P Ref). Management is not particularly sophisticated but there is a strong commitment to competence, they have introduced a code of ethics and, in general, they have a good attitude toward internal control.

Based on our assessment of the internal control environment we should proceed as follows:

1. Materiality will be increased from 10,000 KINR to 15,000 KINR this year to reflect the growth in sales and profitability during the last year.
2. Use the same senior staff as last year and perform the work at the same time. This will provide continuity and audit efficiency. New junior staff will be used.
3. At our team planning meeting to be held on November 15,2008, we need to:
    i. Spend more time considering the susceptibility of the financial statements to fraud;
    ii. Emphasize the use of professional skepticism by our staff;
    iii. Consider the potential for employee fraud and management override. We have no specific reason for suspicion but profit margins have been fluctuating and no one seems to know why;

iv. Focus on the related-party transactions that have been growing.

4. Perform our risk assessment procedures at the end of July 2008. There are no plans to change systems unless the volume of new sales demands it.
5. Attend both the mid-year and year-end inventory counts due to the lack of ongoing inventory internal control procedures.
6. We must keep in touch with senior management to ensure we are informed on a timely basis of any dramatic increase in sales and production. This would cause us to perform additional risk assessment procedures to identify/assess the new risks and management's response to mitigate those risks.
7. Test the operating effectiveness of internal control over sales and payroll (in September 08) so that the extent of our substantive procedures can be reduced. This work will be rolled forward to cover the October–December period.
8. Our IT specialist needs to spend some time at Dephta this year to thoroughly assess the internal control over Internet sales and the general IT controls. As the company grows, IT general controls are becoming more critical and must keep pace.
9. We should expand our testing with regard to related-party transactions. This includes the process for identifying who is a related party and the terms and timing of such transactions.
10. Because of the recent changes in accounting standards and the growth potential in this company and associated risks, we should assign an engagement quality control reviewer to review the file this year.

Understand the Entity and Assess Risk:

ABC Furniture Ltd seems to be following the industry trends, as outlined below.

- The furniture industry is expanding due to a growing economy, availability of skilled labour, government policies that encourage business development, and local lumber mills that can now produce raw materials at a competitive rate.

- ABC Furniture Ltd has a five-year contract for the supply of lumber at fixed prices. The growing industry is also attracting new players and there is some consolidation of smaller manufacturers by larger more profitable manufacturers. ABC Furniture Ltd was approached by a larger company last year that wanted to buy the company. The offer was refused.
- The trend seems to be towards manufacturing standard (lower priced) pieces of furniture for larger retailers as opposed to the traditional practice of custom furniture sold directly to consumers. Retailers are asking for bigger orders but only in exchange for lower prices. This is driving assembly-line style factories with a few standard product lines. ABC Furniture Ltd has supplied two major retailers. There is risk here because the retailers can be very demanding. In the last year, three furniture companies went bankrupt by trying to produce and finance large quantities of goods and orders at slim profit margins.

Sales breakdown is as follows:

Product	**% Sales**
Standard furniture (from catalogue)	40%
Sales to furniture retailers	30%
Internet sales	12%
Made-to-order (custom-built) furniture	15%
Scrap sales from factory	3%

The analysis can be as follows:

- Understanding the laws and regulations applicable to an entity: Companies Act, Income tax Act, etc.
- Key customers : Tata systems ltd, Covansys Inc.

- Key suppliers : Woodies Ltd, Better furns & co., etc.
- Nature of entity—The company does not have a formal governance structure, but the top management prepare a business plan each year and then meet regularly (once a month) with successful local businessman, to review their progress against the plan. They pay local businessman to comment on the practicality of their new ideas for the business, review the operating results, and provide advice on how to deal with any specific issues that have arisen. The company feels that it pays too much in corporate taxes. By comparing actual results to the estimates made in previous years, we identified some instances of management bias. This matter has become a topic of discussion at the closing meeting in each of the last two years.
- Personnel—ABC Furniture Ltd Furniture Inc. has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders where a deadline for order completion exists. During some weeks, there is no need for temporary workers at all; at other times, there can be anywhere from four to eight temporary workers employed. A few of the temporary workers return regularly, but because of the lack of job security, the turnover is quite high.
- All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. ABC Furniture Ltd has always strived to hire the best talent the company can find in the region and pays its full-time employees very competitive rates.
- Individual responsibilities are as follows :
    - Suraj is the managing director of ABC Furniture Ltd. He oversees all aspects of operations and

finances with the help of his assistant, Kamera, who is his daughter-in-law.

- Arjan Singh is in charge of sales and he is assisted by two full-time sales people.
- Dameer looks after production, which includes raw materials ordering and the inventory.
- There are eight full-time production staff members, which includes a production supervisor and one person in charge of quality internal control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.
- Jawad Kassab (a cousin of Suraj) is in charge of the finance function.
- John Rabeer is in charge of IT.
- Management is very involved in the operations. Suraj and Dameer monitor operations and deal with issues as they arise. Job descriptions have been developed and roles and responsibilities are reasonably well defined.

- Key advisors—In addition to the bank manager and Ravi, Parvin (Ravi's daughter and a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin offers some legal advice, but also gets involved with strategy. It was Parvin's idea that ABC Furniture Ltd Furniture should expand its boundaries and start some Internet sales. She also pushed for expansion outside their local region and even to neighbouring countries.
- Financing—HGIQ Bank operating loan secured by receivables and inventory.
- Bonus plans—HGIQ Bank operating loan secured by receivables and inventory. Vinjay – unsecured loan at 12%

repayable over 10 years commencing January 1, 20x4. The debt is convertible to equity if there is ever a default in repaying either interest or the principal on the loan.

- Accounting policies—Revenue is recognized when the goods are shipped. The only exception is the non-refundable 15% deposit taken on large orders, which is recognized as revenue when the deposit is made. This amount has not been material in the last three years. Of more concern are the sales contracts that have provisions for inventory to be returned to ABC Furniture Ltd if it does not sell within a specified time period. This could result in a revenue recognition issue. The other significant accounting policies are as follows :
- Business objectives and strategies—The business plan calls for more expansion beyond local boundaries. This includes more sales to large retailers and marketing to attract Internet sales. Suraj sees this as a great new opportunity to grow the company and become more profitable.
- The implications of growth are :
  - An increased risk of bad debts;
  - A need for sound inventory management to ensure investment levels and obsolescence are minimized;
  - A potential squeeze on working capital;
  - An increased risk of damage in transport;
  - An increased cost of returned merchandise;
  - A need for foreign currency exchange risk management;
  - A need for additional fixed assets;
  - A need for additional craftsmen; and
- **Performance measures**

Suraj watches the gross margin levels very closely. However, because inventory management is not strong, some of the calculated margins may be higher than reality. This has been the subject of a communication to management in the past. Based on our research of the industry, the current margin levels are reasonable.

Risk Table

#	***Account Affected***	***Risk***	***Potent -ial Error *****	***Audit Response ****	***Specific Procedures***
	Pervasive risks				
1	All Accounts	Lack of Working capital	NA	• Consider the need for heightened professional skepticism when examining certain documentation or corroborating significant management representations.	# Analyse the nature of use of current working capital - Long term or short term. # Understand the borrowing powers of the entity and relationship with bankers
2	Income/ Expense	Addition-al crafts-men	NA	• Consider the need to use people with specialized skills/ knowledge.	Understand the availability of skilled labour, possibility of mechanising the operations. Also analyse the impact of Going concern in case of non availability of skilled labour

#	***Account Affected***	***Risk***	***Potent-ial Error *****	***Audit Response ****	***Specific Procedures***
3	Inventory	Techno-logy Obsole-scence	NA	• Consider the need to use people with specialized skills/ knowledge.	Assess the stock in hand for impairment and also impact of going concern for lack of market for the goods produced.
4	Expenses	Foreign Currency Risk mana-gement	NA	• Consider the need to use people with specialized skills/ knowledge.	Since the INR currency is strengthening against the US Dollar, cash flow from revenue has a shortfall. Hence measures can be taken to hedge the risk, say use of derivative instruments.
5	Fixed Assets/ Long term Funds	Capital outflow - Fixed Assets addition-al require-ment	NA	• Introduce an element of unpredictability in the selection of audit procedures. For example, perform procedures on	Analyse the formal budgets in place, impairment of the existing assets and source for the additional requirement.

#	*Account Affected*	*Risk*	*Potent-ial Error *****	*Audit Response **	*Specific Procedures*
				selected account balances and assertions not otherwise tested, adjust the timing of audit procedures, use different sampling methods, or perform procedures on an unannounced basis.	Understand the impact of the capex requirement in the Financial statements.
	Specific risks				
6	Debtors	Risk of Bad debts	Validity	• Request additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements,	# Circulate confirmations for the debtors balance, preferably at an interim date and analyse the responses. # Analyse the reconciliations of various customer balance.

#	*Account Affected*	*Risk*	*Potent -ial Error ** *	*Audit Response **	*Specific Procedures*
				including date, any rights of return and delivery terms.	
7	Revenue	Increase sales return	Validity, Cut off	• Change the nature, timing, and extent of the auditing procedures to address the risk.	# Perform Cut off testing procedures (at the balance sheet date) and ensure revenue is recognised as per the accounting policy in the appropriate period.

* Choose from the procedures from Appendix 6 separately given for pervasive and specific risks

* No potential errors can be addressed to pervasive risks

Appendix 3

Overall Audit Strategy

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Overall Audit Strategy

The overall audit strategy can be established after considering the following :

1. Organise a planning meeting with the clients staff to update our understanding the entity and their accounting process.

   Description :

   Work Paper ref :

2. Consider environmental and industry factors which might identify specific potential risk and document our observation.

   Description :

   Work Paper ref :

3. Perform preliminary analytical procedures and identify any unusual or unexpected balances, and or, relationship which may indicate potential misstatement of the financial statements.

   Description :

   Work Paper ref:

4. Determine planning materiality after assessment of the specific circumstances of the client.

   Description :

   Work Paper ref :

5. Decide whether Involvement of experts is necessary, and any additional risk assessment procedures required for the engagement.

   Description :

   Work Paper ref :

6. Where changes during the year are significant or where factors indicate potential risks, document the details and our specific observations.

   Description :

   Work Paper ref:

7. Prepare debriefing notes on audit including carry forward points of last year. It includes the following:

   - Any audit areas that might require additional or less attention in the future;
   - Any planned changes that will affect future engagements such as an acquisition, new product or service, or the installation of a new accounting system; and
   - Where additional assistance could be provided by the entity such as analysis of certain accounts.

   Description :

   Work Paper ref :

8. Document the assertions that cannot be addressed by substantive tests alone, if any.

   Description :

   Work Paper ref :

9. Assess the need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, and so forth)

Description:

Work Paper ref:

10. Ensure special attention required for any significant risks is given duly while framing the overall audit strategy.

Description:

Work Paper ref:

Appendix 4

Understanding the Entity

Client :	**Prepared by :**	**Date :**
Year :	**Reviewed by :**	**Date :**

Understanding the Entity

During an audit engagement, the below mentioned may be used for understanding the business:

<u>A. External factors:</u>

- Assess the Industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the regulatory environment, including the applicable financial reporting framework.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

- Determine the specific risks arising from the nature of the business or the degree of regulation.

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Determine the legal, political environment and environmental requirements affecting the industry and the entity.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

- Existence of any laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

- Document any other external factors, such as general economic conditions.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

B. Nature of Entity

- Briefly describe of nature of entity's operations

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

- Describe the ownership and governance, including owners, family members, those charged with governance and relationships between owners and other people or entities.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific **(***Tick the appropriate box)*

- Enquire about types of investments (acquisitions, equipment, people, new products, locations, R&D, etc.) that the entity is making and plans to make.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the entity structure (locations, subsidiaries, etc.). Existence of complex structures may give rise to risks of material misstatement such as:

  o Allocation of goodwill and its impairment; and

  o Accounting for investments.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the process in place for identifying related party transactions.

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Ascertain the nature/mode of financing the entity is adopting and also assess the cost for the same.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Ensure the accounting policies appropriate for the business and are in line with industry requirements/ financial reporting framework.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Ascertain the system in place for proper recording of significant and unusual transactions.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Assess whether any significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. If so, consider the effect of using such policies.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

- Check for any changes in the entity's accounting policies during the period. (This includes new financial reporting standards/regulations.) If so :

  - o Document the reasons and consider appropriateness; and
  - o Consider consistency with requirements of the applicable financial reporting framework.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ensure adequate disclosure of material matters in the financial statements. Consider form, arrangement and content of the financial statements and footnotes, classification of items, amount of detail provided and basis of amounts set forth.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

C. Entity Objective and strategies

- Obtain a copy of any mission, vision or values statement produced by the entity (such as in promotional or web-based materials) and consider its consistency with the entity's strategy and objectives. In smaller entities, this information will not often be documented but could possibly be obtained through discussions with management and observation of how they respond to such matters.

  Description :

  Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Identify and document the entity's strategies (that is, operational approaches by which management intends to achieve its objectives).

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Identify and document the entity's current objectives (that is, its overall plans for the entity both short term and long term). In smaller entities, this information will likely be obtained through inquiry of management and observation of how they respond to such matters.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Based on the understanding obtained about mission, vision, business strategies and objectives, identify and document the related business risks.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific **(***Tick the appropriate box)*

- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(*Tick the appropriate box)*

D. Measurement of financial performance

- Identify the key measures used by management to assess the entity's performance and achievement of objectives.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

- Are there external parties that measure and review the entity's financial performance (regulators, franchisors, lending institutions, and so forth)? If so, consider whether copies of such reports should be obtained from the entity (for example, credit rating agency reports).

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (*Tick the appropriate box)*

- Enquire whether performance measures exist to motivate management to take action to:

  o Improve the business performance;

  o Heighten risk by taking aggressive actions to achieve objectives;

  o Meet personal goals such as achieving a bonus threshold;

  o Highlight any unexpected results or trends;

- o Indicate trends or results consistent with the industry as a whole.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ensure performance measures based on reliable information and precise enough to be used as a basis for analytical procedures.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Appendix 5

Understanding the Information System

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Understanding the Information System

The following aspects may be understood and details gathered for risks assessment.

- The IT Governance structure.
- How IT risks are identified, mitigated & managed.
- The Information Plan, strategic plan & budget.
- IT policies, procedures, and standards.
- The organizational structure and segregation of duties
- Acquisitions, configurations, integration, and maintenance of IT infrastructure.
- Delivery of information services to users.
- Management of third-party providers.
- Use of system software, security software, database management systems, and utilities.
- Incident tracking, system logging, and monitoring functions.
- Security of passwords.
- Internet firewalls and remote controls.
- Date encryption and cryptographic keys.
- User accounts and access privilege controls.
- User profiles that permit or restrict access.

- Revoking employee passwords and user IDs when employees resign or are terminated.
- Acquisition and implementation of new applications.
- System development and quality assurance methodology.
- The maintenance of existing applications including controls over program changes.
- Policies and procedures regarding the IT system and reporting that ensure that it is aligned with business requirements.

The information system (which includes the accounting system) consists of the procedures and records established to initiate, record, process, and report the entity's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The following insights may be helpful to understand the business.

1. Obtain Information from the following sources:

- Understand the classes of transactions in the entity's operations that are significant to the financial statements.
- Understand transactions that originate within the entity's business processes.
- Determine the related accounting records (whether electronic or manual), supporting information and specific accounts in the financial statements, in respect of initiating, recording, processing, and reporting transactions.
- Ascertain how the information system captures events and conditions other than classes of transactions that are significant to the financial statements.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

2. Analyse the means of processing of Information:

- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Methods adopted by the entity to communicate financial reporting roles, responsibilities, and significant matters relating to financial reporting.
- Ascertain the risk of material misstatement associated with inappropriate override of controls over journal entries.
- Understand the procedures adopted by management used to:
  - Initiate, record, process, and report significant and non-standard transactions in the financial statements (such as related party transactions and expense reports);
  - Transfer information from transaction processing system to general ledger or financial reporting system;
  - Capture information relevant to financial reporting for events and conditions other than transactions (such as, the depreciation/amortization of assets and changes in the recoverability of accounts receivables);
  - Record and control the use of standard and non-standard journal entries; and
  - Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

- Determine the resolve mechanism in place for incorrect processing of transactions. This could be automated or require manual intervention.
- Determine whether automated controls can be suspended in any circumstances and effects if they fail to operate.
- Process of exceptions reported and their disposal.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

3. Uses of Information produced

- Understand the range of reports regularly produced by the information system and use to the management.
- What information is provided by management to those charged with governance and to external parties, such as, regulatory authorities.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Impact of Information Technology Controls

The auditor should obtain an understanding of how the entity has responded to risks arising from IT. This IT controls in place is very relevant for designing procedures for risks identified.

<u>Analysis of IT Controls and Risks Associated with them</u>

4. Examine the predefined business rules and complex calculations involved in processing large volumes of transactions or data.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

5. Ascertain the timeliness, availability, and accuracy of information.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

6. Determine the ability of the Information system in place to facilitate the additional analysis of information.

   Description :

   Risk Identified:

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

7. Determine the ability to monitor the performance of the entity's activities and its policies and procedures.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

8. Assess for any risk in the internal control that may be circumvented.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

9. Assess the ability to achieve effective segregation of duties by implementing security internal control in applications, databases, and operating systems.

   Description :

   Risk Identified:

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

10. Assess the degree of Reliance on systems or programs that may be inaccurately programmed, processing inaccurate data, or both.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

11. Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions particular risks may arise where multiple users access a common database).

    Description :

    Risk Identified:

    Nature of risk: □ Pervasive □ Account balance specific (*Tick the appropriate box)*

12. Assess the possibility of IT personnel gaining privileges beyond those necessary to perform their assigned duties.

    Description:

    Risk Identified:

    Nature of risk: □ Pervasive □ Account balance specific (*Tick the appropriate box)*

13. Ensure no unauthorized changes to data are made in master files.

    Description :

    Risk Identified:

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

14. Ensure no unauthorized changes are made to systems or programs.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

15. Determine failure to make necessary changes to systems or programs.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

16. Ascertain for any chances of inappropriate manual intervention.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

17. Enquire for any potential loss of data or inability to access data as and when required.

    Description :

    Risk Identified:

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Appendix 6

Risk Assessment Procedures

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Risk Assessment Procedures

A. Inquiries with Management

The processes in place for identifying and responding to the risks of fraud and error in the financial statements.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Management communication in place to employees regarding its views on business practices, adherence to policies and procedures, and ethical behavior.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Ascertain the potential for management override of controls in place.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Inquire whether there is a history of fraud happenings or there is any suspected fraud.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Assess the strength of financial statement preparation and review process.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

B. Analytical Procedures

Develop expectations about plausible relationships among the various types of information that could reasonably be expected to exist. Seek to use independent sources of information (that is, not internally generated) where possible.

Such financial and non-financial information could include:

Financial statements for comparable previous periods;

Budgets, forecasts, and extrapolations, including extrapolations from interim or annual data; and

Information regarding the industry in which the entity operates and current economic conditions.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Compare expectations with recorded amounts or ratios developed from recorded amounts and summarize below:

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

C. Observation/Inspection

Inspect documents such as:

- Business plans and strategies;
- Accounting policies and records;
- Internal control manuals;
- Reports prepared by management (such as interim financial statements); and
- Other reports such as minutes from meetings of those charged with governance, reports from consultants, etc.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Test of Controls

Assess the necessity for testing internal control during the engagement. Where internal control exists and is expected to operate effectively, consider:

- Whether testing controls would achieve an effective response to the assessed risk of material misstatement for a particular assertion; and
- What substantive testing could be reduced by performing tests of controls.

Even in a very small entity, there are often well-designed and effective controls over revenues that, if tested, could reduce the extent of substantive procedures required. If testing the operating effectiveness of internal control would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to assessed risks for specific assertions. No credit can be taken for the effective operation of controls that have not been tested.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

- Identify whether any assertions that can only be effectively addressed by tests of controls.

  In some cases, suitable substantive procedures (to obtain evidence for a particular assertion) may not be available, so tests of controls will be necessary. An example of this would be highly automated systems with little or no paper trail available. If such internal control is not considered reliable (controls are not likely to operate effectively) or is absent, the auditor will have to determine whether it is possible at all to obtain sufficient appropriate audit evidence.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Substantive Procedures

Data Reliability

- Assess whether data obtained from sources within the entity or from independent sources outside the entity (Independent sources are generally more reliable).

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Assess whether data from sources within the entity developed by persons not directly responsible for its accuracy (If so, consider further procedures to check on accuracy).

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (Tick the appropriate box)

- Ensure reliability of data developed with adequate internal control.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (Tick the appropriate box)

- Determine whether broad industry data comparable for use within the entity is available.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (Tick the appropriate box)

- Ascertain whether the data subject to audit testing in the current or prior periods and tailor the procedures.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific
  (Tick the appropriate box)

- Ensure that the auditor's expectations regarding recorded amounts developed from a variety of sources.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Timing, Extent of Procedures

Determine the Timing, Extent of Procedures after considering the following:

- Purpose of the test and assertions will be addressed;
- The experience (if any) in performing similar tests in previous periods;
- Population of items to be tested be defined;
- Sampling technique to be used;
- Disposal of deviation in the sample;
- Specific (substantive) items that could be excluded from the sample and evaluated separately;
- Subgroups within the defined population that could be tested separately;
- Level of confidence is required from the test;
- Maximum deviation rate that is tolerable.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Conclusions drawn from such procedures corroborate the conclusions formed during the audit of individual components or elements of the financial statements

Description :

Appendix 7

Risk Table

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Risk Table

No.	*Account Affected*	*Risk (Refer Appendix 6)*	*Poten tial Error*	*Overall Audit Response (Refer Appendix 9)*	*Specific Proce-dures*	*Wkp Ref.*
	Pervasive risks					
1						
2						
3						
4						
5						
	Specific risks					
6						
7						
8						
9						
10						

Appendix 8

Steps for Risk Identification

Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.

Determine the likelihood for assessed risk to occur and its impact on our auditing procedures.

Document the assertions that are effected.

Consider the impact of the risk on each of the assertions (completeness, existence, accuracy, validity, valuation and presentation) relevant to the account balance, class of transactions, or disclosure.

Identify the degree of Significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.

Enquire and document the management's response.

Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Ensure the controls :

- Routine in nature (occur daily) or periodic such as monthly.
- Designed to prevent or detect and correct errors.
- Manual or automated.

Consider any unique characteristics of the risk.

Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures. Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Possible potential misstatements - Indicators
> Completeness
Transactions not identified.
Source documents not prepared.
Source documents not captured.
Rejected source documents not represented.
> Existence
Fictitious or unauthorised transactions entered on source documents.
Source documents overstated.
Transactions duplicated on source documents.
Capture of source documents duplicated.
Invalid source documents captured on subsidiary ledgers.
> Recording
Source documents captured inaccurately.
Processing of transactions is inaccurate.
Inaccurate adjustments made in subsidiary ledgers.
> Cut-Off Procedures
Transactions that occur in one period are recorded in another period.

Appendix 9

Overall Responses Relating to the Financial Statements in General

- **Pervasive Risks Exist at the Financial Statements Level**
  - Consider the need for heightened professional skepticism when examining certain documentation or corroborating significant management representations.
  - Consider the need to use people with specialized skills/knowledge, such as information technology (IT).
  - Introduce an element of unpredictability in the selection of audit procedures. For example, perform procedures on selected account balances and assertions not otherwise tested, adjust the timing of audit procedures, use different sampling methods, or perform procedures on an unannounced basis.
- **Specific Responses Relating to Risks at the Assertion Level**
  - Change the nature, timing, and extent of the auditing procedures to address the risk. Examples include the following:
    - Obtain more reliable and relevant audit evidence or additional corroborative information to support management assertions.
    - Perform a physical observation or inspection of certain assets.
    - Observe inventory counts on an unannounced basis.

  - Perform further review of inventory records to identify unusual items, unexpected amounts and other items for follow-up procedures.
  - Perform further work to evaluate the reasonableness of management estimates and the underlying judgments and assumptions.
  - Increase sample sizes or perform analytical procedures at a more detailed level.
- o Use Computer-Assisted Audit Techniques (CAATs).
  - Gather more evidence about data contained in significant accounts or electronic transaction files;
  - Perform more extensive testing of electronic transactions and account files;
  - Select sample transactions from key electronic files;
  - Sort transactions with specific characteristics, and
  - Test an entire population instead of a sample.
- o Request additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements, including date, any rights of return and delivery terms.
- o Change the timing of substantive procedures from an interim date to near the period end. If a risk of intentional misstatement or manipulation exists, audit procedures to extend audit conclusions from

an interim date to the period end would not be effective.

Risks Related to Management Override

Review of Journal Entries

- Identify, select, and test journal entries and other adjustments based on the following:
    - An understanding of the entity's financial reporting process and design/implementation of internal control;
    - Characteristics of fraudulent journal entries or other adjustments;
    - Presence of fraud risk factors that relate to specific classes of journal entries and other adjustments; and
    - Inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity.

Estimates

- Review estimates relating to specific transactions and balances to identify possible biases on the part of management. Further procedures could include the following:
    - Reconsidering the estimates taken as a whole;
    - Performing a retrospective review of management's judgments and assumptions related to significant accounting estimates made in the prior year; and
    - Determining whether the cumulative effect of the bias amounts to a material misstatement in the financial statements.

Significant Transactions

- Obtain an understanding of the business rationale for significant transactions that are unusual or outside the normal course of business;

  This includes an assessment as to whether:

  - Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
  - The arrangements surrounding such transactions appear overly complex;
  - Management has discussed the nature of and accounting for such transactions with those charged with governance;
  - 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;
  - Transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance; and
  - There is adequate documentation.

Risks Related to Management Override

Revenue Recognition

- Perform substantive analytical procedures. Consider Computer-Assisted Audit Techniques to identify unusual or unexpected revenue relationships or transactions;
- Confirm with customers relevant contract terms (acceptance criteria, delivery, and payment terms) and the absence of side agreements (right to return the product, guaranteed resale amounts, and so forth).