

Course: Financial Audit

Lecture 10: Main Audit Concept and Planning

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Overview of Lecture 9

Audit Sampling

- Audit sampling refers to the process of applying audit procedures to a selection of less than the total items within an account balance or transaction class.
- Through this selective examination, auditors can obtain insights about specific characteristics of the chosen items, which aids them in forming or supporting a conclusion about the entire group, or population, from which these items originate. Importantly, audit sampling allows for both statistical and non-statistical methodologies.
- In the context of statistical sampling, a random sample is one drawn in such a way that each possible combination of sampling units has an identical chance of being chosen. Although this distinction may initially appear minor, it has significant implications. In ISAs, the main criterion is that all sampling units merely have a "chance of selection," contrasting with the statistical expectation of equal probability across combinations.

Audit Sampling

- The purpose of ensuring that each sampling unit has a chance of selection is to form conclusions about the population as a whole. Statistical sampling leverages knowledge of all possible samples that might be taken from the population, providing confidence that the sample results reflect the broader group.
- In this standard, an "error" refers either to control deviations when conducting tests of control or to misstatements when executing substantive procedures.
- A misstatement arises when there is a difference between the book value, or recorded value in the client's accounts, and the audit value, which the auditor determines to be accurate.

Audit Sampling

- An anomalous error refers to an error stemming from a unique, isolated event that occurs infrequently or under specific circumstances. This type of error is not seen as representative of the population's error pattern.
- The "population" consists of all the data points from which a sample is drawn, representing the full set of items relevant to the auditor's testing objectives. Populations may be divided into strata, or sub-groups, with each stratum examined separately, facilitating focused analysis within each subgroup.

Sampling Risk

- Sampling risk is the possibility that conclusions based on a sample might differ from those that would have been drawn had the entire population been examined. Two main types of sampling risk are:
 - Type 1 (Risk of Over-Reliance)
 - Type 2 (Risk of Under-Reliance)

Sampling Risk

- Non-sampling risk refers to errors that may occur independent of the sample size, such as errors resulting from the auditor's judgment. This could include the auditor using incorrect procedures, misinterpreting evidence, or overlooking significant errors due to the persuasive nature of most audit evidence.
- A sampling unit refers to the individual elements that make up a population. This could include items such as checks on deposit slips, credit entries on bank statements, sales invoices, customer balances, or even a single monetary unit.

Statistical Sampling

- Statistical sampling involves two key elements:
 - Random Selection
 - Probability Theory
- Stratification is the technique of dividing a population into sub-populations, or strata, each containing sampling units with similar characteristics, often related to monetary value. This division enhances the sample's relevance and precision.
- Tolerable error denotes the maximum error the auditor is willing to accept within the population while still reaching a valid conclusion.

Testing

- In alignment with ISA 500, "Audit Evidence," audit evidence is gathered from a blend of control tests and substantive procedures. The choice of testing approach significantly impacts the audit procedures used to gather evidence.
- Per ISA 400, tests of control are carried out if the auditor intends to assess control risk below the high level for a particular assertion. The auditor, based on an understanding of the accounting and control systems, identifies specific attributes indicating effective control.
- Audit sampling is especially suited for tests of control when evidence of control application is traceable.

Substantive Procedures

- Substantive procedures, focused on validating financial figures, are comprised of two key types: analytical procedures and tests of transaction and balance details. These procedures are crucial for identifying potential material misstatements within the financial statements.
- When performing substantive tests, auditors may employ audit sampling or other methods to evaluate assertions about financial statement amounts or develop independent estimates, for instance, in assessing the value of outdated inventory.
- These tests provide the needed assurance on account balances and help identify any substantial inaccuracies.

Audit Risk

- In gathering evidence, auditors use their professional judgment to assess and mitigate audit risk, designing their audit procedures to ensure this risk remains at an acceptable minimum. This requires a balanced and insightful approach to selecting and performing audit procedures based on assessed risk levels.
- Audit risk arises when an auditor issues an incorrect audit opinion on financial statements that are materially misstated. This risk is categorized into three elements:
 1. Inherent Risk
 2. Control Risk
 3. Detection Risk

Audit Risk

- Sampling and non-sampling risks contribute to overall audit risk in various ways. For example, in control tests, an auditor might wrongly conclude that control risk is low when the sample shows no errors, even if the population error rate is unacceptably high.
- Conversely, non-sampling risk may occur if the auditor fails to notice errors in the sample. In substantive testing, detection risk can be managed through carefully selected methods, though these may be vulnerable to both sampling and non-sampling risks.

Procedures

- Procedures for obtaining audit evidence include inspection, observation, inquiry, confirmation, computation, and analytical techniques. The appropriate choice depends on the auditor's professional judgment and the context of the audit.
- When crafting audit procedures, auditors must choose how to select items for testing. The main methods available include:
 - 100% Examination of all items within a population;
 - Selective Examination of specific items based on characteristics; and
 - Audit Sampling involving a sample of the population.

Procedures

- In some cases, the auditor might opt for a complete examination of all items within an account balance or transaction class. Although rarely applied in control tests, 100% examination is more common in substantive testing, especially when there are a few high-value items or when both inherent and control risks are high, requiring comprehensive evidence.
- Auditors might selectively examine certain items within a population based on factors such as their understanding of the client's operations, initial assessments of inherent and control risks, and other relevant characteristics of the population.
- While selective examination is an efficient way to gather evidence, it differs from audit sampling as the findings from these specific items cannot be extended to the whole population.

Procedures

- Audit sampling, either non-statistical or statistical, can be applied to assess account balances or transaction classes. The choice between these methods hinges on auditor judgment and depends on the specific audit context.
- The auditor's decision to use statistical or non-statistical sampling depends on which approach offers the most efficient way to gather adequate and suitable evidence.
- When auditors apply statistical sampling, they may determine the sample size using probability theory or rely on professional judgment. Sample size alone does not distinguish statistical from non-statistical approaches; rather, it is the sampling methodology that defines the approach.

Procedures

- In some instances, auditors may use elements of statistical sampling, such as random selection, without fully meeting the criteria of statistical sampling. However, statistical measures of sampling risk are only valid when all elements of statistical sampling are strictly applied.
- When creating an audit sample, the auditor must focus on the objectives of the test and understand the attributes of the population from which the sample will be taken. This ensures that the sample is relevant to the audit's goals and representative of the population's characteristics.
- Initially, the auditor assesses the specific objectives of the audit test, alongside the set of procedures likely to best fulfill these objectives.

Procedures

- The auditor establishes what conditions qualify as an error according to the test objectives. Clearly defining an error ensures that only conditions relevant to the test objectives are factored into error projections.
- When performing tests of control, auditors often conduct a preliminary assessment of the expected error rate within the population and the control risk level. This preliminary assessment may be based on prior experience or an initial examination of a small sample.
- To maintain audit accuracy, auditors ensure the sampled population is both relevant to the test objective and complete. If the goal is to test for understatement, the population might instead include subsequent disbursements, unpaid invoices, or suppliers' statements.

Procedures

- Audit efficiency may improve when populations are divided into sub-populations, or strata, based on distinct characteristics. Stratification aims to reduce item variability within each group, allowing sample sizes to be minimized without increasing sampling risk.
- In substantive procedures, account balances or transactions are often stratified by monetary value, directing more audit effort toward high-value items. Alternatively, stratification may focus on characteristics associated with higher error risk, such as age when testing accounts receivable valuation.
- Results from a sample within a stratum can only be generalized to that specific stratum. For an overall conclusion on the population, auditors consider both materiality and risk.

Procedures

- Monetary unit sampling, often used for overstatement testing, defines the sampling unit as individual monetary units within a balance or transaction class. When monetary units are randomly selected, the larger items, which contain more of these units, have a higher probability of selection, directing audit focus to potentially significant misstatements.
- Auditors determine sample size based on the acceptable level of sampling risk. Lower acceptable risk requires a larger sample size, as it enhances confidence that the sample represents the population accurately.
- For each selected item, the auditor performs the designated audit procedures. If an item is not suitable for testing, the auditor substitutes it with a comparable replacement that can be tested.

Procedures

- Occasionally, a selected item may lack documentation, making it impossible to perform the planned procedures. In such cases, the auditor may treat the item as an error unless alternative procedures, such as reviewing subsequent receipts, are available and appropriate.
- After testing, the auditor reviews the sample findings, analyzing any detected errors and their causes. This evaluation helps in understanding the implications for the test objectives and identifying potential effects on other audit areas.
- When performing control tests, the auditor's main focus is on evaluating the design and operation of the controls and assessing control risk.

Procedures

- If the errors discovered share common characteristics the auditor might identify all items with these characteristics and perform further testing in that stratum.
- In some instances, the auditor may conclude that an error is an isolated event, unlikely to recur, and not representative of the. To confirm this, the auditor performs additional testing to gather sufficient evidence.
- In substantive testing, auditors project identified monetary errors to the population and assess the impact on the audit objective and other areas. This projected total error gives an overview of error magnitude in relation to the tolerable misstatement, which is typically set at or below the preliminary estimate of materiality for the audited account balances.

Procedures

- When a population is divided into strata, the auditor projects errors separately for each stratum. Projected errors, along with any anomalous errors, are then combined to evaluate the potential effect on the total account balance or transaction class.
- The auditor reviews sample results to confirm or adjust the preliminary assessment of the population characteristic in question. If control tests reveal a higher error rate than expected, the auditor may raise the control risk assessment.
- If projected errors, including anomalous errors, are near the tolerable level, the auditor considers the strength of the sample results and may gather additional audit evidence. Recognizing that sampling involves risk, the auditor understands that a different sample might yield an error estimate exceeding the tolerable threshold.

Procedures

- When sample results suggest that the preliminary assessment of population characteristics needs adjusting, the auditor may:
 - Ask management to investigate and address the identified errors and make necessary adjustments.
 - Modify planned audit procedures, such as expanding the sample size, testing alternative controls, or altering related substantive procedures.
 - Consider the effect of these findings on the audit report.

Quality Control

- According to International Standard on Quality Control 1 (ISQC 1), audit firms must establish a quality control system to ensure compliance with professional standards and regulatory and legal requirements, and that issued reports are appropriate.
- Quality control policies cover general activities and personnel, including leadership roles in quality, client acceptance and retention, engagement performance, and monitoring. Policies on human resources emphasize ethical compliance, which should be documented and communicated to all personnel.
- Policies should support a firm culture valuing quality in engagements, with ultimate responsibility assigned to the CEO or managing board with appropriate expertise.

Quality Control

- Firms must establish policies to ensure ethical compliance, including independence as required by IFAC and national ethics standards. Personnel must report any independence breaches, and the firm should take corrective actions.
- Firms must have policies for accepting and continuing client engagements that provide reasonable assurance in decision-making. When continuing an engagement or accepting a new one with an existing client, any complex issues should be documented along with their resolutions.
- Prospective clients should be evaluated, and ongoing reviews of current clients should be conducted. The firm must monitor the quality control system continuously to ensure policies remain effective and communicate these policies to all personnel.

Quality Control

- Audit firms should establish policies requiring quality control reviews for audits of financial statements, especially for listed entities, to evaluate significant judgments made by the engagement team.
- Policies must ensure quality control systems are relevant, adequate, and effective, with regular reviews of completed engagements.
- Audit firms should ensure they have sufficient personnel with the necessary competencies and ethical commitment to perform engagements per professional and legal standards. Each engagement should have an assigned partner with the appropriate capabilities and authority to oversee the work, supported by skilled staff.

SOX

- The Sarbanes-Oxley Act (SOX) sets comprehensive standards for auditing practices, including oversight requirements such as rigorous quality control protocols, mandatory second-partner reviews, and periodic rotation of audit partners to prevent familiarity threats.
- SOX also delineates the roles and duties of a client's audit committee, including oversight functions and mandatory inspections by the Public Company Accounting Oversight Board (PCAOB).
- The PCAOB retains authority to decide if foreign accounting firms, even those that do not directly issue audit reports, should be subjected to SOX regulations if they significantly contribute to the preparation or verification of these reports.

SOX

- To ensure robust quality assurance across audits, the PCAOB administers a systematic and continuous inspection program that assesses the adherence of audit firms to PCAOB standards and regulatory requirements.
- Under SOX Section 104, registered audit firms must undergo PCAOB inspections that include a thorough review of selected audit engagements, which may involve complex cases under litigation or contentious issues with third parties.
- The PCAOB prepares a written report detailing its findings and submits this to appropriate regulatory bodies.

SOX

- In evaluating whether to accept or continue an audit engagement, an audit firm must consider potential conflicts of interest with former employees and maintain rotation protocols for lead auditors. An audit firm is prohibited from offering audit services if a former employee, within the preceding year, has held a critical financial with a client that they audited.
- Independent reviews of audit work are mandated, with internal or external partners not directly involved in the audit providing objective assessments. According to SOX Section 103, an audit must undergo a second-partner review by a qualified person not associated with the audit, or an independent external reviewer, ensuring impartiality. SOX Section 303 further prohibits any public accounting firm from providing audit services if the lead or reviewing audit partner has served the client for each of the last five fiscal years, ensuring a regular change in audit perspectives.

Audit

- Essential governance evidence should be gathered throughout the audit, particularly before finalizing judgment and evaluation in Phase IV of the Audit Process Model. The auditor must scrutinize legal documents, contracts, board meeting minutes, and management correspondence to assess whether any contingent liabilities exist that could impact financial reporting.
- The auditor will consult with management to understand the policies for identifying, evaluating, and documenting contingencies. The auditor will request details on all outstanding contingencies as of the balance sheet date and require written confirmation from management that all unasserted claims with a need for disclosure have been addressed.

Audit

- One of the primary methods auditors use to detect client litigation, claims, and assessments is through a legal letter, also known as an attorney inquiry. The auditor analyzes the client's legal expenses from the current and past years and requires the client to issue a standard letter to each of their legal advisors.
- The legal counsel's letter provides the auditor with insights into any ongoing litigation and other pertinent matters involving legal issues that could impact the client's financial status.
- According to the International Standard on Auditing 580, auditors must obtain proof that management accepts responsibility for fair representation of the financial statements per the relevant framework and has formally approved the financial statements.

Audit

- Auditors can secure this evidence from the minutes of board meetings, a signed copy of the financial statements, or a formal written representation from management.
- If reliable audit evidence is not reasonably available, auditors should seek written representations from management on material financial statement matters. This can be documented in working papers, summarizing discussions with management or through written statements.
- Such written representations can take the form of a management representation letter or an auditor-prepared letter summarizing management's assertions, which management then acknowledges and confirms.

Audit

- A contingent liability is a possible future obligation to an external party, resulting from past events and often subject to uncertain outcomes, such as unfavorable tax rulings or litigation. Disclosures are typically required if the potential for loss is likely, as stipulated by financial reporting standards.
- Testing for contingencies is an ongoing process, starting at the audit's inception. Auditors assess potential risks, such as tax disputes, regulatory investigations, and unused bank credit facilities, early on.
- To identify contingencies, auditors often use legal letters, examine client working papers, check letters of credit for used and unused balances, and evaluate known liabilities.

Audit

- Similar to contingent liabilities, commitments represent agreements that bind the entity to specific future conditions, such as fixed-price purchase agreements, leases, and sales contracts.
- Related parties are defined as individuals or entities with control or influence over the client, making related-party transactions critical areas for auditors.
- Auditors must ensure sufficient evidence exists to confirm accurate identification and disclosure of related-party transactions, as misstatements could lead to incomplete financial statements. IAS 24 mandates disclosure of transaction volume and nature with related parties, emphasizing transparency.

Audit

- Given the inherent risk of related-party transactions, auditors should carry out specific procedures to gather conclusive evidence, identifying circumstances indicating misstatement risks.
- The auditor is responsible for examining information provided by directors and management to identify transactions with related parties, as these could impact the financial statements. This review involves verifying management information to ensure that all known related parties are accounted for.
- If the auditor cannot gather sufficient evidence about these parties or believes that disclosures are inadequate, they must modify their audit report to reflect these limitations.

Audit

- After the balance sheet date, auditors perform procedures to identify and evaluate significant events, known as subsequent events, which may impact the presentation of the financial statements.
- Under International Standard on Auditing (ISA) 560, auditors assess the implications of these events on the financial statements and the audit report, ensuring any material changes are appropriately disclosed to reflect an accurate picture of the company's financial condition as of the report date.
- In the concluding stages of an audit, auditors conduct procedures to verify that the financial statements and accompanying disclosures, such as those for corporate governance or management reports, are sufficient.

Audit

- A key task for auditors in finalizing an audit is ensuring that disclosures in financial statements are complete. Adequate disclosure includes all financial statements and necessary footnotes, which provide additional context and detail.
- The SOX Act imposes specific obligations on auditors regarding financial statement disclosures. According to Section 404, public companies must include an internal control report in their annual filings, demonstrating management's responsibility for an effective internal control framework.
- Auditors, as mandated by PCAOB Audit Standard #2, must independently evaluate and confirm management's assessment. Publicly listed companies must disclose all material adjustments, off-balance-sheet transactions, and other critical financial information, and pro forma data must align with the company's financial condition.

Audit

- Auditors continuously monitor the adequacy of disclosures throughout the audit process. The auditor must also classify current versus non-current receivables and disclose any factoring or discounting of notes receivable, ensuring consistent application of accounting standards from one year to the next.
- Many audit firms employ disclosure checklists designed by independent partners or directors. These checklists serve as reminders of potential disclosure challenges and ensure the comprehensive review of the entire audit to identify and address any disclosure issues before finalizing the audit report.
- Shareholders globally are increasingly concerned about governance, prompting measures like the London Stock Exchange's requirement for companies to adhere to a Code of Best Practice, as recommended by the Cadbury Committee.

Audit

- SOX mandates that companies disclose whether they have adopted a code of ethics for senior financial officers, such as the CFO or chief accounting officer, and explain if they have not.
- Section 407 of SOX also requires companies to disclose whether their audit committee includes at least one financial expert, with reasons given if this criterion is not met, ensuring transparency and accountability at the executive level.
- According to SA 720, the auditor should examine other information presented alongside audited financial statements to identify any material inconsistencies. This other information may include annual reports, management reports, and data on the company's operational highlights, such as planned capital expenditures and employment data.

Audit

- A material inconsistency occurs when other presented information conflicts with audited financial data, potentially affecting the auditor's opinion. If identified, the auditor must determine whether amendments are needed in the financial statements or the other information.
- If auditors find that other information contains a material misstatement of fact, they discuss the issue with management. Should management disagree, the auditor may recommend consulting a third-party expert, such as legal counsel, to resolve the matter.
- Concluding procedures, or wrap-up, are performed at the end of an audit. These include supervisory review, final analytical tests, working paper assessment, client approval of necessary adjustments, legal review, and going concern evaluation.

Audit

- Wrap-up procedures begin with the senior accountant's review of staff work, followed by the manager and partner reviewing the submitted findings.
- Before completing the audit, the senior accountant must confirm that all audit procedures have been conducted according to the initial planning memorandum, objectives have been met, and audit standards adhered to.
- During the final review, any questions or issues raised by the manager or partner typically require additional documentation in the working papers, addressing the reporting standards checklist to confirm compliance.

Audit

- The senior auditor gains the manager's approval that fieldwork is complete before leaving the client's site. Typically, the manager will spend time reviewing the audit working papers, ensuring all audit programs have been fully executed, and sufficient evidence exists to support the audit opinion.
- Working papers record all phases of the audit, including the planning, procedures performed, results, and conclusions drawn. They act as the primary support for the auditor's opinion and serve as proof that an adequate audit was conducted.
- An independent review of working papers, conducted by an audit firm member uninvolved in the audit, ensures objectivity and quality. This independent review verifies that the audit aligns with professional standards and firm policies.

Audit

- After completing tests on each financial statement item, the auditor signs off, documenting any monetary misstatements and suggesting adjustments as needed.
- The auditor assesses uncorrected misstatements by examining known misstatements, likely misstatements and an allowance for undetected misstatements.
- Auditors must be well-versed in laws relevant to their clients, conducting tests to confirm that client companies meet the necessary legal standards and identifying any high-risk areas that may warrant further examination.
- Regulatory bodies may review publicly traded companies that meet high-risk criteria. Understanding these criteria enables auditors to anticipate potential issues and ensure their clients comply with relevant regulations.

Audit

- The assumption that a business will continue operating is essential for financial statement preparation. ISA 570 emphasizes that auditors must assess whether this assumption is reasonable based on the entity's circumstances, ensuring that assets and liabilities reflect the company's ongoing operations.
- Matters for Attention of Partners (MAPs) documents critical audit decisions made by audit managers and the partner's conclusions on these matters.
- The board oversees financial policies, hires auditors, and receives audit findings. Auditors may attend board meetings to discuss key matters such as internal controls, ensuring any unresolved issues receive the necessary attention.

Conclusion & Closing

Lecture 10: Main Audit Concept and Planning

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014