CPA IRELAND

GUIDANCE ON SUCCESFULLY APPLYING A RISK BASED AUDIT APPROACH

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I. PURPOSE OF ARTICLE

1. The main purpose of this Article is to provide guidance to candidates sitting the 2007 AUDITING exams regarding the effective application of a risk-based audit approach throughout the various stages of the audit, particularly the transaction internal control assessment and testing and financial statements substantive testing stages, as well as key related concepts, as set by International Standards on Auditing (ISA).

II. OVERVIEW OF 2007 EXAMS AND IMPACT OF CHANGE IN RISK BASED APPROACH EMPHASIS

1. The 2007 exams will cover the same knowledge syllabus areas and have the same format and feel as the 2006 exams.

2. However, there will be increasing emphasis placed on the practical use of risk based auditing in those questions where it is raised, with a lesser emphasis placed on regurgitation of risk based audit approach theory, which will still be tested.

3. For example, whereas in previous exams, a candidate might simply be asked to reproduce a receivables confirmation, in future exams, candidates could also be asked, in addition to reproducing the receivables confirmation, what critical financial statement assertions the receivables confirmation validates (valuation, existence, ownership), as well as the impact of strong/weak corresponding internal controls (credit check on new customers/ credit limit check on new sales) on your performance of this substantive audit procedure. So candidates will be required to demonstrate their understanding of such relationships not only within the general context of the Audit Risk Equation, but also within the context of key financial statement assertions for a particular financial statement item.

4. In summary, candidates will still be required to know the same body of audit risk based auditing knowledge as before, but will be asked, more often, to justify and explain what they are doing, as demonstrated in the examples in 3. Thus, for example, the major focus of internal control focus and financial statements substantive testing questions will remain the same, that is the identification and resolution of internal control weaknesses and the stating and performance of substantive audit procedures, with some additional risk-based audit approach practical considerations factored in.

5. As always, a portion of each question's marks, ranging from 25% to 75%, will require candidates to access case information. This is very much a knowledge based exam, with only 1 presentation mark awarded, as always, for the ubiquitous internal control management letter.

6. A summary explanation of risk based audit approach and some key ISA related concepts are provided in Section III, partly reflecting some areas of difficulties experienced by candidates on the 2006 exams.

III. EXAMPLES OF POTENTIAL AUDIT RISK BASED APPROACH APPLICATION ISSUES RAISED ON 2007 AUDITING EXAMS

(Using as a practical example, the audit of revenue and receivables)

1. Impact of existence internal control of relevance of weakness / results of internal control procedures compliance test on related substantive testing of concerned financial statement assertion.

   Examples:

   1.1 Non-existence of credit checks / non-effectiveness of credit check control tested' will result in increased substantive procedures on the valuation of revenue and receivables (more detailed analysis of bad debts / increased confirmations sample size …)

   1.2 Poor management attitude in relation to controls (weak control environment) also has adverse impact.

   Candidates should be able to express the above dynamics in the Audit Risk Equation format.

   What the examiner is looking for:
   Candidate's ability to link internal control weaknesses /strengths identified to a particular financial statement assertion for the corresponding item

2. Selection of appropriate audit procedures and audit evidence in order to provide assurance on financial statement assertion at hand

   Examples:
   2.1 Justification of key substantive audit procedures you listed to test receivables:
   Valuation/existence/ownership based: receivable confirmation
   Valuation based: bad debt analysis …

   What the examiner is looking for:
   Candidate's ability to apply correct substantive audit procedures in order to satisfy particular assertion(s), rather than dumping set of audit procedures blindly

   Likely exam question in which this issue may be raised: Question 2 / Question 4

3. Integrated response to a particular accounting computer system: major threats / mitigating controls/ audit approach and audit procedures for compliance testing and substantive

   Examples:
   Major systems: stand alone versus network, online processing versus batch, EDI versus hard
   copy documents, multiple data bases versus DBMS
   Major threats: unauthorized access, continuity of operations, accuracy of data ….
   Major controls: system based versus application based
   Major audit procedures types: CAATS versus manual

   What the examiner is looking for:
   Candidate's ability to resolve computer system issues using an integrated approach.

IV. EXPLANATION OF KEY RISK BASED AUDIT APPROACH AND RELATED CONCEPTS

1. Risk based audit approach definition and explanation

Approach whereby the auditors identify and assess the **risks of material misstatement** at the financial statement level and at the **assertion** level for classes of transactions, account balances and disclosures.

This is accomplished in four steps:
1. Identify risks throughout the process of obtaining an understanding of the entity
2. Relate the risks to what can go wrong at assertion level
3. Consider whether the risks are of a magnitude that could result in a material misstatement
4. Consider the likelihood of the risks causing a material misstatement

The auditor then determines the nature, timing and extent of audit procedures to respond to those risks, in maintaining detection risk at an appropriate level.

2. Explanation of above critical concepts – (Financial Statement) **Assertions**

2 A. Key assertions (balance sheet items/income statement items; same if no /))
1.Valuation/measurement 2. Existence/occurrence 3.Completeness
4.Rights and obligations 5. Presentation and disclosure

2.B Important consideration: in a profit seeking entity environment there is a natural bias towards the overstatement of assets and revenues and the understatement of liabilities and expenses. Hence, critical financial statement items assertions to focus on in a risk-based audit approach:
1. assets: existence / valuation (not overvalued) / ownership (proof of)
2. liabilities: completeness/valuation (not undervalued)/ownership (concealment of)/non-disclosure. Note: the auditor, will also focus on other 'less risky' assertions, but will apply less effort.

3. Explanation of above critical concepts - Risks

3A. **Risks of material misstatements in the financial statements**
Risks of material misstatements in the financial statements = Inherent Risk X Control Risk as in the Audit Risk Equation 'Audit Risk = **Inherent Risk X Control Risk** X Detection Risk'

3B. Other risks of importance: business risks and significant risks:
- Significant risks: transactions reflecting unusual, complex , subjective based transactions, arising from new developments, high risk of fraud.
- Business risks: risks inherent to the company and its operations (operational/ financial/ compliance)

3C. Significant risks and business risks are both components of:

- inherent risks (risk financial statement items/disclosure materially misstated dues to the characteristics of the items) : by virtue of the nature of significant risks and business risks
- control risks (risk client controls of relevance fail to detect material misstatements), which would be reflected in the failure of controls established to assess business risk and monitor significant risks

4. Explanation of internal control of relevance in relation to control risk

4A. Definition and description

Internal control pertinent to the auditor's duty to provide assurance on financial statement items ISA breaks down internal control of relevance into 5 segments:

1. Control environment
2. Entity's business risk assessment process
3. Information activities
4. Control activities (procedures)
5. Control monitoring

4B. Auditor's responsibility in relation to internal controls of relevance under ISA

1. Document (along with accounting systems)
2. Assess in relation to its effectiveness in preventing material misstatements from occurring in the corresponding financial statement item, with this assessment ideally performed on a
financial statement assertion level basis (e.g.: no credit checks -> adverse impact on receivables valuation (increased likelihood of bad debts).
3. Effective internal control procedure exists for financial statement items assertions to validate:
perform compliance testing through financial year for proof of occurrence of control (e.g.: initial of person performing credit check) and proof of effectiveness (credit check
blocked the processing of customers already exceed their credit limits) in order to validate that receivables are properly valued (not overvalued) on the financial statements.
(concept of dual-purpose testing).
4. Note the offsetting impact of effective internal control procedures continual and effective application on control risk and acceptable detection risk as expressed in the Audit Risk Equation: $AR = IR \times CR (\uparrow) \times DR (\downarrow)$ or $AR = IR \times CR (\downarrow) \times DR (\uparrow)$, assuming $IR = k$

5. Materiality

- A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditor's report. Note the auditor is concerned with not only net profit materiality, but also with financial statement presentation materiality and disclosure (in notes) materiality.

- Materiality, like audit risk (risk of issuance of wrong audit opinion) is set at the very beginning of the audit, before the other audit risk equation components, based on such factors as the nature of the addresses of the financial statements and their intended reliance, and the financial situation and performance of the company.