Audit Workshop – Part 1

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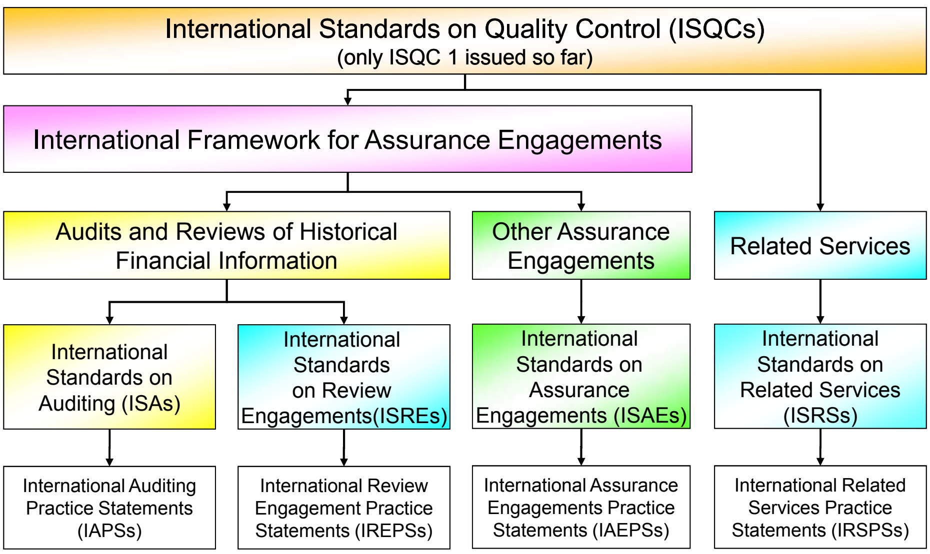
Overview



Overview

International Standards on Quality Control (ISQCs)
(only ISQC 1 issued so far)

International Framework for Assurance Engagements

Audits and Reviews of Historical Financial Information

International Standards on Auditing (ISAs)

International Auditing Practice Statements (IAPSs)

Overview

Activity

International Standards on Quality Control (ISQCs)
(only ISQC 1 issued so far)

- Activity 1 – Introduction
  - The partner of MTK CPA, Melody Tong, seeks your sharing on the critical issues of the practices introduced by ISAs and briefing to the engagement team.

International Standards on Auditing (ISAs)

Overview

ISA 200 & 230

ISA 300, 315 & 330

International Standards on Auditing (ISAs)

- ISA 200 – 299
  General Principles and Responsibilities
- ISA 300 – 499
  Risk Assessment & Response to Assessed Risks
- ISA 500 – 599
  Audit Evidence
- ISA 600 – 699
  Using Work of Others
- ISA 700 – 799
  Audit Conclusions and Reporting

Overview

One of the Critical Requirements in Today's Audit

ISA 300 – 499
Risk Assessment & Response to Assessed Risks

Our focus today:

- ISA 300 Planning an Audit of Financial Statements
- ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- ISA 330 The Auditor's Procedures in Response to Assessed Risks

Audit Process Overview

Audit Process

Planning	Preliminary engagement activities → Planning activities
Risk assessment	Understanding the entity and its environment → Identify and assess risks of material misstatements
Risk response	Design and implement auditor's responses to assessed risks
Reviewing and reporting	Overall reviewing → Drawing conclusions and reporting

An audit is a cumulative and iterative process

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Agenda for Part 1 and Part 2

Planning	Preliminary engagement activities → Planning activities
Risk assessment	Understanding the entity and its environment → Identify and assess risks of material misstatements
Risk response	Design and implement auditor's responses to assessed risks

Today's Agenda

Planning

- Preliminary engagement activities
- Planning activities

Planning an Audit

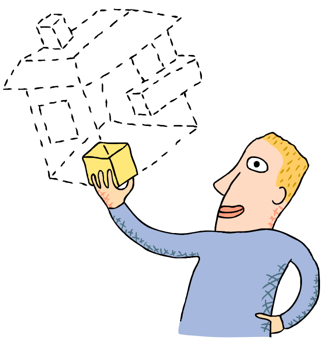
- The objective of the auditor is to plan the audit so that it will be performed in an effective manner. (ISA 300.4)
- The issues involved are:
  - What shall be involved in such a plan?
  - What shall be the nature, timing and extent of such plan?
  - What are the benefits in planning the audit?

Planning – Benefits

- Adequate planning can have the following benefits:
  - Helping the auditor to devote appropriate attention to important areas of the audit.
  - Helping the auditor identify and resolve potential problems on a timely basis.
  - Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
  - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
  - Facilitating the direction and supervision of engagement team members and the review of their work.
  - Assisting, where applicable, in coordination of work done by auditors of components and experts

Planning – Nature, Extent & Timing

- **Nature and extent**
  - The nature and extent of planning activities will vary according to
    - the size and complexity of the entity,
    - the auditor's previous experience with the entity, and
    - changes in circumstances that occur during the audit engagement.
  - **What should be involved in the planning?**
- **Timing**
  - **What is the timing of the planning?**



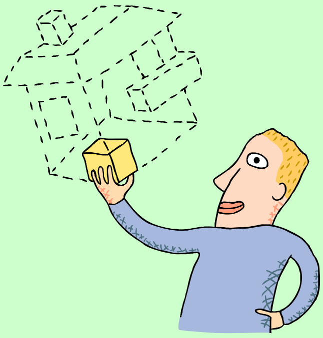
Planning – Overview

Activity

Activity 2 – Planning

– **What should be involved in the planning?**

– **What is the timing of the planning?**



Planning – Overview

ISA 300 Planning an Audit of Financial Statements

1. Involvement of Key Engagement Team Members
2. Preliminary engagement activities
3. Planning activities
4. Documentation
5. Additional considerations in initial audit engagement

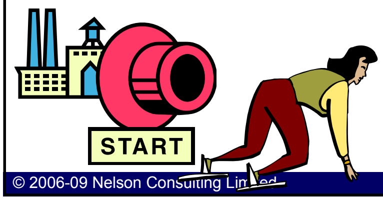
Planning

- The engagement partner and other key members of the engagement team shall be involved in planning the audit,
  - including planning and participating in the discussion among engagement team members. (ISA 300.5)

Preliminary Engagement Activities

Preliminary engagement activities

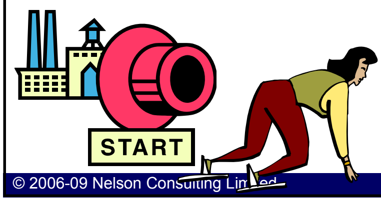
- The auditor shall undertake the following activities at the beginning of the current audit engagement:
  a. Performing procedures required by ISA 220 regarding the continuance of the client relationship and the specific audit engagement;
  b. Evaluating compliance with relevant ethical requirements, including independence, in accordance with ISA 220; and
  c. Establishing an understanding of the terms of the engagement, as required by ISA 210. (ISA 300.6)



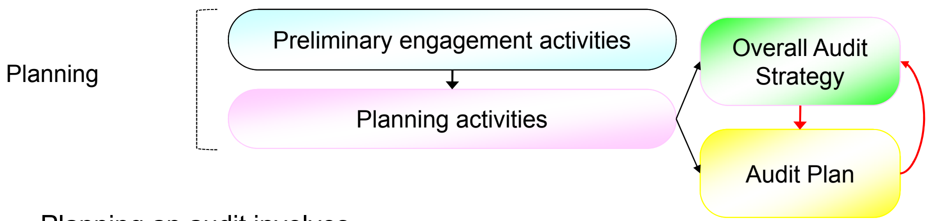
Preliminary Engagement Activities

Preliminary engagement activities

- Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:
  - The auditor maintains the necessary independence and ability to perform the engagement.
  - There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
  - There is no misunderstanding with the client as to the terms of the engagement.



Planning Activities



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

Planning – Overall Audit Strategy

- 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. (ISA 300.7)

Overall Audit Strategy

Planning – Overall Audit Strategy

- In establishing the overall audit strategy, the auditor shall:
  a. Identify the characteristics of the engagement that define its scope;
  b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
  c. Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
  d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
  e. Ascertain the nature, timing and extent of resources necessary to perform the engagement. (ISA 300.8)

Overall Audit Strategy

Planning – Overall Audit Strategy

Example

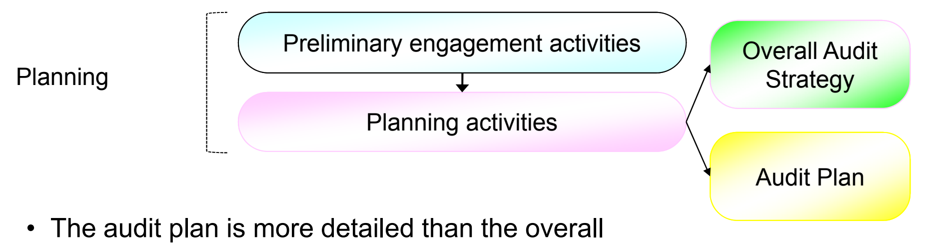
- In establishing the overall audit s... auditor shall:
  a. Identify the characteristics of the... define its scope;
  b. Ascertain the reporting objective... to plan the timing of the audit an... communications required;
  c. Consider the factors that, in the ... professional judgment, are signif... engagement team's efforts;
  d. Consider the results of prelimina... activities and, where applicable, ... gained on other engagements p... engagement partner for the entit...
  e. Ascertain the nature, timing and ... necessary to perform the engag...

- Financial reporting framework used
- Industry-specific reporting requirements
- Locations of the components of the entity

- Reporting deadlines (interim & final)
- Key dates for expected communication with management and those charged with governance

- Determine materiality levels
- Identify potential areas with higher risks of material misstatement
- Identify material areas, balances & etc.
- Evaluate whether plan to test the effectiveness of internal control
- Identify recent significant entity-specific, industry, or other developments

Planning – Audit Plan



- The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members.

Planning – Audit Plan

Planning

Preliminary engagement activities

Planning activities

Overall Audit Strategy

Audit Plan

- 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 ISA 315.
  b. The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.
  c. Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (ISA 300.9)

Risk Assessment Procedures

Further Audit Procedures

Other Audit Procedures

Planning – Audit Plan

Example

Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

For example, planning of the auditor's risk assessment procedures ordinarily occurs early in the audit process.

However, planning of the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

The auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Risk Assessment Procedures

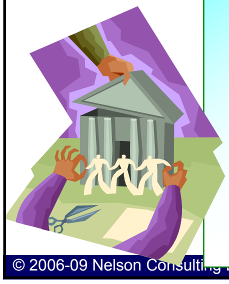
Further Audit Procedures

Other Audit Procedures

Planning – Audit Plan

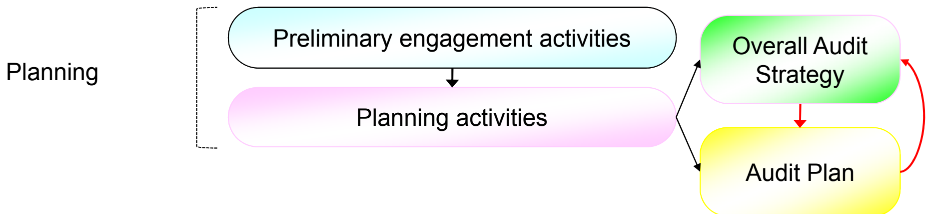
Example

- In planning an audit, the auditor may also consider the timing of <u>certain planning activities and audit procedures that need to be completed prior to the performance of further audit procedures</u>.



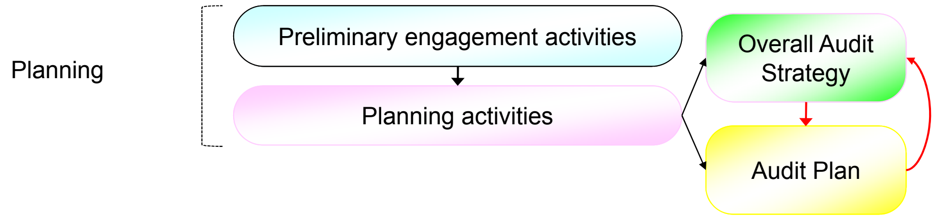
- Prior to identifying and assessing the risks of material misstatement and performing further audit procedures, the auditor can perform the following planning activities at the beginning of the current engagement:
  1. the discussion among engagement team members,
  2. the analytical procedures to be applied as risk assessment procedures,
  3. the obtaining of a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework,
  4. the determination of materiality,
  5. the involvement of experts and
  6. the performance of other risk assessment procedures

Planning Activities



- The auditor shall <u>update and change</u> the overall audit strategy and the audit plan as necessary during the course of the audit. (ISA 300.10)
- The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (ISA 300.11)

Planning – Continual and Iterative



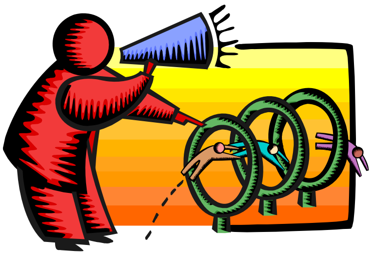
- Planning is not a discrete phase of an audit, but rather <u>a continual and iterative process</u> that
  - often begins shortly after (or in connection with) the completion of the previous audit and
  - continues until the completion of the current audit engagement.

Planning – Continual and Iterative

Example

- As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures,
  - the auditor may need <u>to modify the overall audit strategy and audit plan</u>, and
  - thereby <u>the resulting planned nature, timing and extent of further audit procedures</u>.
- Information may come to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.
- The auditor may obtain audit evidence through the performance of substantive procedures that contradicts the audit evidence obtained with respect to the testing of the operating effectiveness of controls.
  - In such circumstances, the auditor re-evaluates the planned audit procedures, based on the revised consideration of assessed risks at the assertion level for all or some of the classes of transactions, account balances or disclosures.

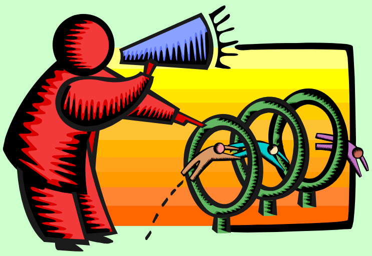
Planning – Documentation



- The auditor shall include in the audit documentation:
  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. (ISA 300.12)

Planning – Documentation

Sample



Preliminary Engagement Activities

Overall Audit Strategy

Audit Plan

Considerations in an Initial Audit

- The auditor shall undertake the following activities prior to starting an initial audit:
  a. Performing procedures required by ISA 220 <u>regarding the acceptance of the client relationship and the specific audit engagement;</u> and
  b. <u>Communicating with the predecessor auditor</u>, where there has been a change of auditors, in compliance with relevant ethical requirements. (ISA 300.13)

Considerations in an Initial Audit

- For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:
  – Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
  – Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
  – The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.
  – Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of second partner)

Planning an Audit

Planning

- Preliminary engagement activities
- Planning activities

Overall Audit Strategy

Audit Plan

Changes to Planning Decisions During the Course of the Audit

Today's Agenda

- Preliminary engagement activities
- Planning activities

Risk assessment

- Understanding the entity and its environment
- Identify and assess risks of material misstatements

Purpose

- ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
  - ➢ One of the critical requirements in ISAs

Risk assessment

- Understanding the entity and its environment
- ↓
- Identify and assess risks of material misstatements

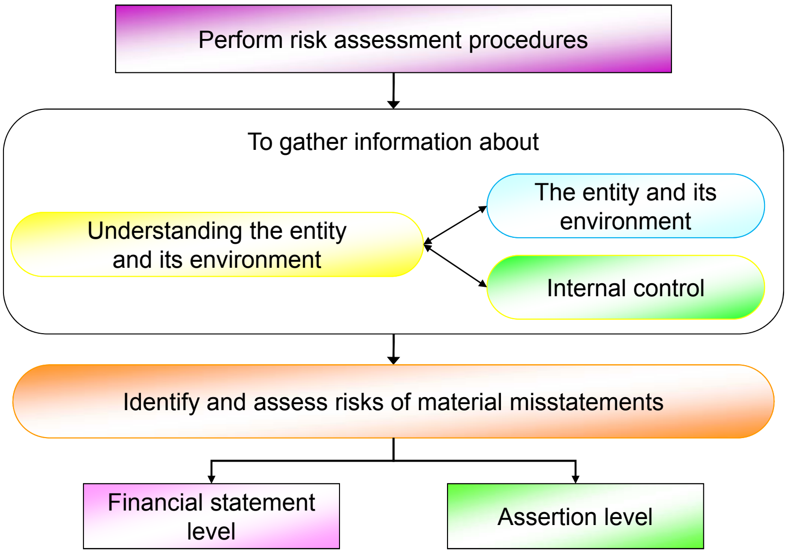
- The objective of the auditor is
  - ➢ to identify and assess the risks of material misstatement, whether due to fraud or error, at
    - – the financial statement and assertion levels,

    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.

Purpose

- Obtaining an understanding of the entity and its environment
  - – establishes a frame of reference within which the auditor
    - plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example when:
      - – Establishing materiality and evaluating materiality for individual items
      - – Considering the appropriateness of the selection and application of accounting policies
      - – Identifying areas where special audit consideration may be needed
      - – Developing expectations for use in performing analytical procedures
      - – Designing and performing further audit procedures
      - – Evaluating the sufficiency and appropriateness of audit evidence obtained

Risk Assessment Overview



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Risk Assessment Procedures

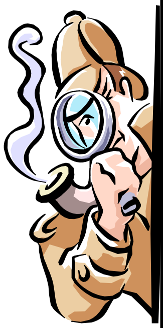
Perform risk assessment procedures

- The auditor shall perform risk assessment procedures
  - to provide a basis for the identification and assessment of risks of material misstatement
    - at the financial statement and assertion levels.
- Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (ISA 315.5)

Risk Assessment Procedures

Perform risk assessment procedures

- 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.
  b. **Analytical procedures**.
  c. **Observation** and **inspection**. (ISA 315.6)

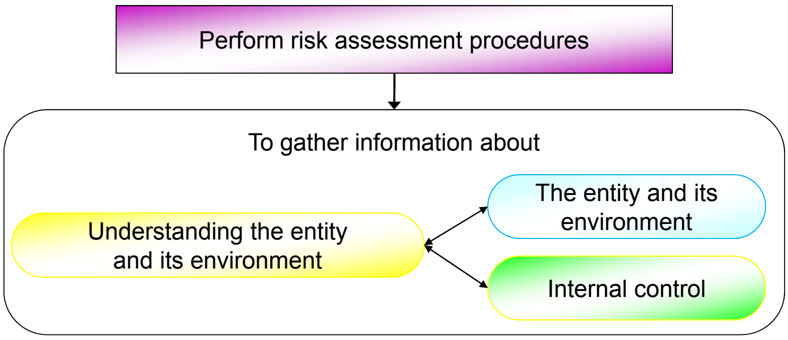


Risk Assessment Procedures

Perform risk assessment procedures

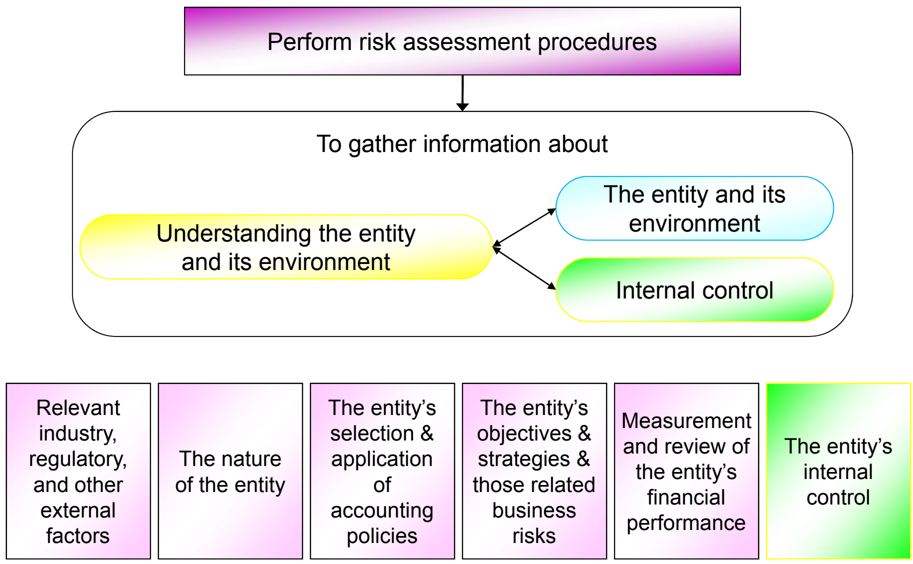
- The auditor shall
  - consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
  - consider whether information obtained from other engagements (if any) is relevant to identifying risks of material misstatement
  - determine whether changes have occurred since the previous audit that may affect its relevance to the current audit (If intends to use information obtained from previous audits).
  - 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
  - determine which matters are to be communicated to engagement team members not involved in the discussion.

Understanding the Entity



- Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit.

Understanding the Entity



The Entity and Its Environment

- The auditor shall obtain an understanding of the following:
  a. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
  b. The nature of the entity, including its operations, ownership and governance structures, the type of investments, the organization structure and etc.
  c. The entity's selection and application of accounting policies, including the reasons for changes thereto.
  d. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
  e. The measurement and review of the entity's financial performance.
  (ISA 315.11)

Relevant industry, regulatory, and other external factors	The nature of the entity	The entity's selection & application of accounting policies	The entity's objectives & strategies & those related business risks	Measurement and review of the entity's financial performance

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Internal Control

- The auditor shall obtain an understanding of internal control relevant to the audit.
  – Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.
  – It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (ISA 315.12)

The entity's internal control

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Internal Control

- The auditor shall obtain an understanding of the following components of internal control:

The Control Environment

The Entity's Risk Assessment Process

The Information System

Control Activities

Monitoring of Controls

The entity's internal control

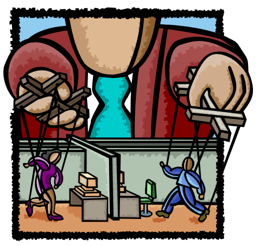
Internal Control

The Control Environment

Obtain an understanding of the control environment. (ISA 315.14)

The Entity's Risk Assessment Process

Obtain an understanding of whether the entity has a process for
a. identifying business risks relevant to financial reporting objectives
b. estimating the significance of the risks
c. assessing the likelihood of their occurrence
d. deciding about actions to address those risks. (ISA 315.15)



The entity's internal control

Internal Control

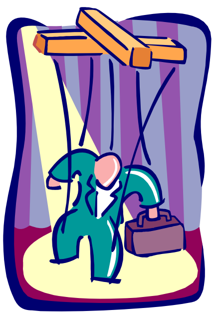
- The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. (ISA 315.19)

The Information System

Obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

a. The significant classes of transactions;
b. The procedures by which transactions are initiated, recorded, processed, corrected as necessary, transferred to the G/L and reported in the financial statements;
c. The related accounting records, supporting information and specific accounts in the F/S;
d. How the information system captures events and conditions;
e. The financial reporting process used to prepare the entity's financial statements; &
f. Controls surrounding journal entries. (ISA 315.18)

Internal Control



Control Activities

- The auditor shall obtain an understanding of control activities relevant to the audit (not all control activities), being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.
- In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (ISA 315.20-21)

Internal Control

Monitoring of Controls

- The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (ISA 315.22)

Understanding the Entity

Perform risk assessment procedures

To gather information about

Understanding the entity and its environment

The entity and its environment

Internal control

Relevant industry, regulatory, and other external factors	The nature of the entity	The entity's selection & application of accounting policies	The entity's objectives & strategies, and related business risks	Measurement and review of the entity's financial performance	The entity's internal control

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Understanding the Entity

Sample

Perform risk assessment procedures

To gather information about

Understanding the entity and its environment

The entity and its environment

Internal control

Template (Key Points) on Understanding an Entity and Environment

Understanding the Entity

Perform risk assessment procedures

To gather information about

Understanding the entity and its environment

The entity and its environment

Internal control

Identify and assess risks of material misstatements

Financial statement level

Assertion level

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Today's Agenda

Preliminary engagement activities

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Planning activities

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Risk assessment:

- Understanding the entity and its environment

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- Identify and assess risks of material misstatements

Identifying and Assessing Risks

- What is audit risk? What is risk of material misstatement?

- ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* states that audit risk as:
    - ➢ The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
    - ➢ A function of
        - the risks of material misstatement and
        - detection risk.

Identifying and Assessing Risks

Audit Risk

Risk of Material Misstatement

Detection Risk

- ISA 200 specifically states that
  - In conducting an audit of financial statements, the overall objectives of the auditor are ...... to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement …… (ISA 200.11)
  - To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (ISA 200.17)

Identifying and Assessing Risks

Audit Risk

Risk of Material Misstatement

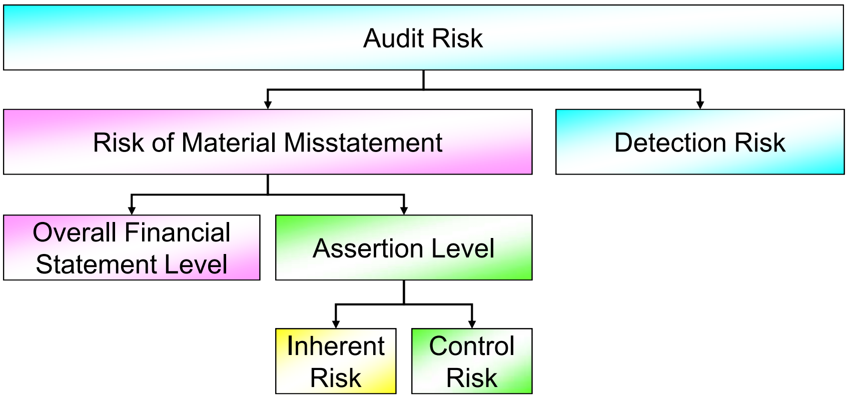
Detection Risk

Overall Financial Statement Level

Assertion Level

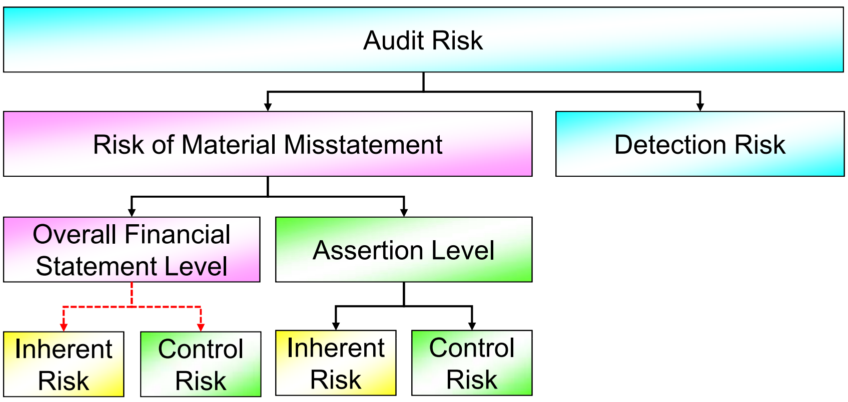
- ISA 200 further states that
  - The risks of material misstatement may exist at two levels:
    1. The overall financial statement level; and
    2. The assertion level for classes of transactions, account balances, and disclosures.

Identifying and Assessing Risks



- ISA 200 also states that the risks of material misstatement at the assertion level consists of two components:
  1. Inherent risk
  2. Control risk

Identifying and Assessing Risks



- Even ISA 200 only states that inherent risk and control risk are considered at the assertion level, it is also common for the auditor to consider them at the overall financial statement level.

Identifying and Assessing Risks

Risk of Material Misstatement

- Overall Financial Statement Level
- Assertion Level

- Based on this audit risk framework, ISA 315 thus states (as discussed) that:
  - 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 ......

Identifying and Assessing Risks

Perform risk assessment procedures

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To gather information about

- Understanding the entity and its environment
  - The entity and its environment
  - Internal control

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Identify and assess risks of material misstatements

- Financial statement level
- Assertion level

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Identifying and Assessing Risks

- By performing risk assessment procedures and based on the understanding of the entity obtained,
  - the auditor shall identify and assess the risks of material misstatement at:
    a. the **financial statement level**; and
    b. the **assertion level** for classes of transactions, account balances, and disclosures

    to provide a basis for designing and performing further audit procedures. (ISA 315.25)

Identify and assess risks of material misstatements

Financial statement level | Assertion level

Identifying and Assessing Risks

- For the purpose of identifying and assessing the risks of material misstatement, the auditor shall:
  a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
  b. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
  c. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
  d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. (ISA 315.26)

Financial statement level | Assertion level

Risks at Financial Statement Level

- Risks of material misstatement at the financial statement level refer to risks that
  - relate pervasively to the financial statements as a whole and
  - potentially affect many assertions.
- Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.
  - Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control.
- Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

Financial statement level

Risks at Financial Statement Level

Example

- Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example,
  - deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:
  - Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
  - Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

Risks at Financial Statement Level

Activity

Activity 3 – Planning and Response

- Based on the Case in Activity 3
  - assess the risk of material misstatements at the financial statement level.
  - write down the specific circumstances of ABC that you have considered and your judgment about the risk level (i.e. low, medium, or high)

Financial statement level

Risks at Assertion Level

- Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered
  - because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.
- In identifying and assessing risks of material misstatement at the assertion level,
  - the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertion level

Risks at Assertion Level

- The risks of material misstatement at the assertion level consists of two components as follows:
  1. Inherent risk
     – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  2. Control risk
     – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- Both risks are the entity's risks; they exist independently of the audit of the financial statements.

Assertion Level

Inherent Risk | Control Risk

Assertion level

Risks at Assertion Level

- The Use of Assertions
  – In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

Class of Transactions

Account Balances

Presentation and Disclosure

Assertion level

Risks at Assertion Level

Activity

Activity 4 – Risks of Material Misstatement at the Assertion Level

- Melody, Tony and Kurt and Company, CPA (MTK CPA), has accepted to audit the consolidated financial statements of Bonnie Limited for 2007 and 2008.
- MTK CPA is required to implement the requirements of International Standards on Auditing.
- Required:
  - The partner of MTK CPA, Melody Tong, seeks your sharing on the requirements on assertion level and briefing to the engagement team the different kinds of assertions.

Class of Transactions

Account Balances

Presentation and Disclosure

Assertion level

Risks at Assertion Level

- Assertions used by the auditor fall into the following categories:
  - About Classes of Transactions and Events for the period under audit
    - Occurrence
    - Completeness
    - Accuracy
    - Cutoff
    - Classification
  - About Account Balances at the period end
    - Existence
    - Rights and obligations
    - Completeness
    - Valuation and allocation
  - About Presentation and Disclosure
    - Occurrence and rights and obligations
    - Completeness
    - Classification and understandability
    - Accuracy and valuation

Class of Transactions

Account Balances

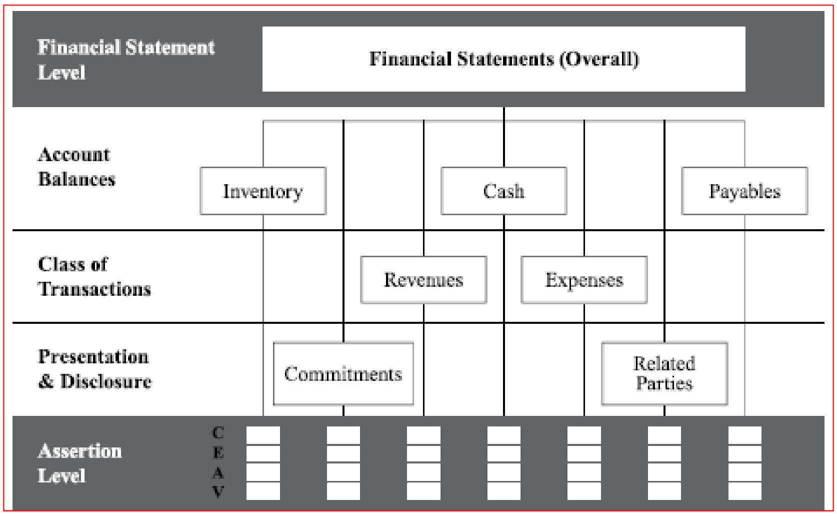
Presentation and Disclosure

Risks at Assertion Level

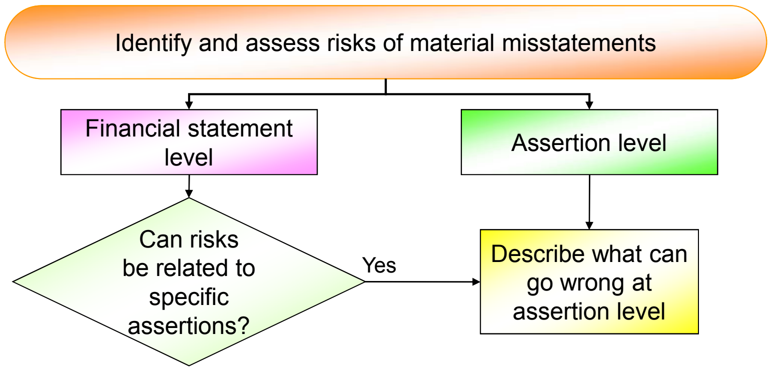
- Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities (by IFAC SMPC):
  - To make the use of assertions a little easier to apply to smaller entities, the Guide has combined the assertions into 4 combined assertions as follows:

Combined Assertions	Classes of Transactions	Account Balances	Presentation and Disclosure
Existence	Occurrence	Existence	Occurrence
Completeness	Completeness	Completeness	Completeness
Accuracy and Cut-off	Accuracy Cut-off Classification	Rights and obligations	Accuracy Rights and obligations Classification and understandability
Valuation		Valuation and allocation	Valuation

Risks at Assertion Level



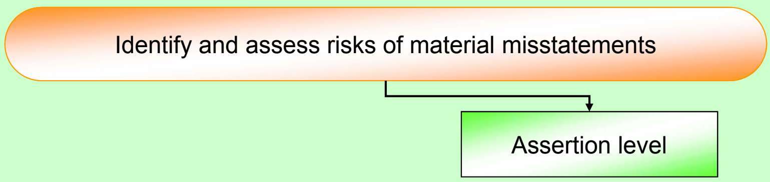
Risks at Assertion Level



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Risks at Assertion Level

Activity



<u>Activity 5 – Risks at Assertion Level</u>

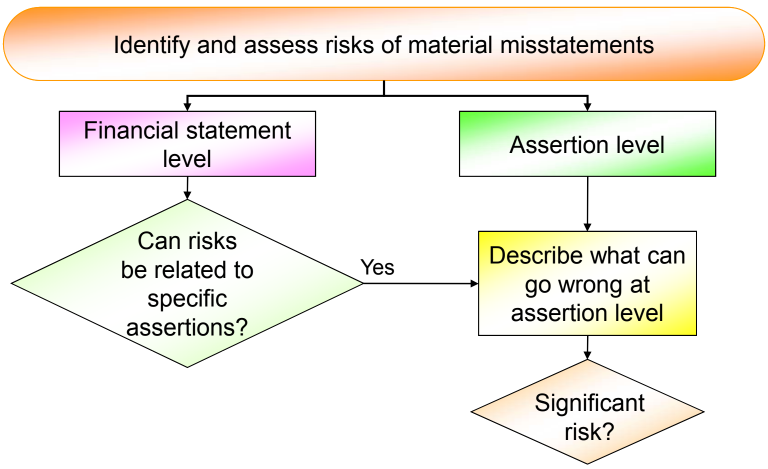
- Based on the Case of ABC in Activity 3 and regarding the consignment sales of ABC:
  - Identify the major audit issues in ABC's consignment sales recognition for the purpose of assessing the risk of material misstatement at the assertion level.

Determining Significant Risks

- As part of the risk assessment, 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. (ISA 315.27)

- Significant risk is
  - ➢ an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Determining Significant Risks



Determining Significant Risks

- In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
  a. Whether the risk is a risk of fraud;
  b. Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
  c. The complexity of transactions;
  d. Whether the risk involves significant transactions with related parties;
  e. The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
  f. Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (ISA 315.28)

Determining Significant Risks

- Significant risks often relate to significant non-routine transactions or judgmental matters.
  - **Non-routine transactions** are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.
  - **Judgmental matters** may include the development of accounting estimates for which there is significant measurement uncertainty.
- Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

Determining Significant Risks

Example

- Risks of material misstatement may be greater for risks relating to significant non-routine transactions arising from matters such as:
  - Greater management intervention to specify the accounting treatment.
  - Greater manual intervention for data collection and processing.
  - Complex calculations or accounting principles.
  - The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

- Risks of material misstatement may be greater for risks relating to significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
  - Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
  - Required judgment may be subjective, complex or require assumptions about the effects of future events, for example, judgment about fair value.

Determining Significant Risks

- If 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. (ISA 315.29)

Significant risk?

Determining Significant Risks

- Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls,
  - management may have other responses intended to deal with such risks
  - accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks.
- Such responses might include:
  - Control activities such as a review of assumptions by senior management or experts.
  - Documented processes for estimations.
  - Approval by those charged with governance.

Significant risk?

Determining Other Risks

Risks for which Substantive Procedures Alone do not Provide Sufficient Appropriate Audit Evidence

- In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.
  - Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention.
  - In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them.

Any examples?

Determining Other Risks

Example

- Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements.
  - Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions, such as an entity's revenue, purchases, and cash receipts or cash payments.
  - Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk.

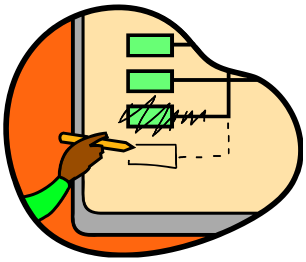
Determining Other Risks

Example

- For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system.
- In such cases:
  - Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
  - The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

Revision of Risk Assessment

- The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.
- In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall
  - revise the assessment and
  - modify the further planned audit procedures accordingly.



Revision of Risk Assessment

Example

- During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based.
- For example:
  - The risk assessment may be based on an expectation that certain controls are operating effectively.
    - In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit.
  - In performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments.
    - In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements.

Documentation

- The auditor shall include in the audit documentation:
  a. The discussion among the engagement team where required by ISA 315.10 (susceptibility to material misstatement), and the significant decisions reached;
  b. Key elements of the understanding obtained regarding each of the aspects
     - of the entity and its environment specified in ISA 315.11 and
     - of each of the internal control components specified in ISA 315.14-24;

     the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
  c. The identified and assessed risks of material misstatement
     - at the financial statement level and
     - at the assertion level as required by ISA 315.25; and
  d. The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in ISA 315.27-30.

Agenda for Part 2

Planning	Preliminary engagement activities ↓ Planning activities
Risk assessment	Understanding the entity and its environment ↓ Identify and assess risks of material misstatements
Risk response	Design and implement auditor's responses to assessed risks

Audit Workshop – Part 1

5 December 2009

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