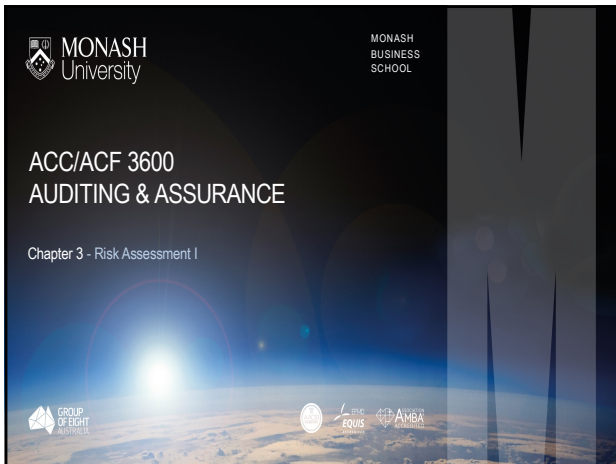




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MONASH BUSINESS SCHOOL

LEARNING OBJECTIVES

AFTER READING THIS CHAPTER YOU SHOULD BE ABLE TO:

- 3.1 explain the **different phases** of an audit
- 3.2 relate the process used in **gaining an understanding of the client**
- 3.3 evaluate **fraud risk**
- 3.4 explain the **going concern assumption**
- 3.5 appraise **corporate governance structures**
- 3.6 evaluate how **a client's information technology (IT)** can affect risk
- 3.7 demonstrate how **client closing procedures** can affect reported results.

Adapted from Moroney, Robyn, et al. (2017), *Auditing: A practical approach* (3rd ed.), Wiley

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MONASH BUSINESS SCHOOL

STAGES OF AN AUDIT

1. **Risk assessment phase**
 - Understanding the client
 - Risk identification and strategy
 - Risk and materiality assessment
2. **Risk response phase**
 - Tests of control
 - Substantive testing
3. **Reporting phase**
 - Conclusion and forming an opinion

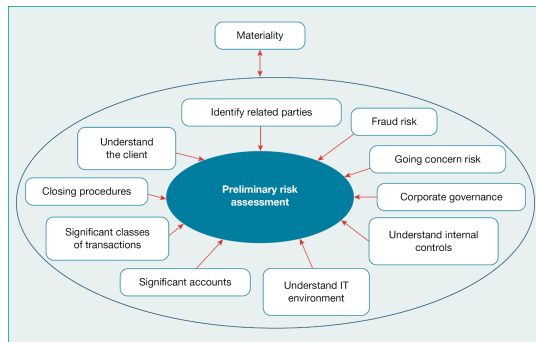
```
graph LR; subgraph RA [Risk assessment phase]; U[Understanding the client]; RIS[Risk identification and strategy]; RMA[Risk and materiality assessment]; end; subgraph RR [Risk response phase]; TC[Tests of control]; ST[Substantive testing]; end; subgraph RP [Reporting phase]; C[Conclusion and forming an opinion]; end; RA --> RR; RR --> RP;
```

Adapted from Moroney, Robyn, et al.

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RISK ASSESSMENT



Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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STAGES OF AN AUDIT

Risk response involves detailed **tests of controls and substantive testing of transactions and accounts**

- Covered in detail in chapters 8-11

Reporting involves **evaluating results** of detailed testing in light of the auditor's understanding of their client and **forming an opinion** on the truth and fairness of the client's financial report

- Covered in detail in chapter 12

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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GAINING AN UNDERSTANDING OF A CLIENT

According to ASA 315; ISA 315, **gaining an understanding of the client** is necessary to assess the risk that the financial report contains a material misstatement due to:

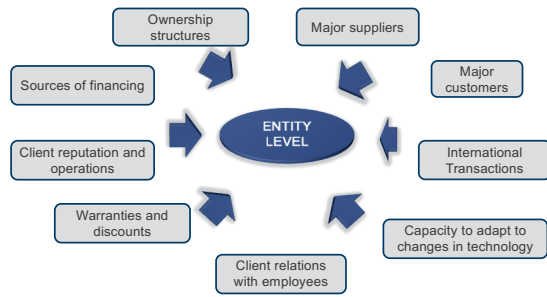
- The **nature** of the client's business
- The **industry** in which the client operates
- The level of **competition** within that industry
- The client's **customers and suppliers**
- The **regulatory environment** in which the client operates

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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GAINING AN UNDERSTANDING OF A CLIENT

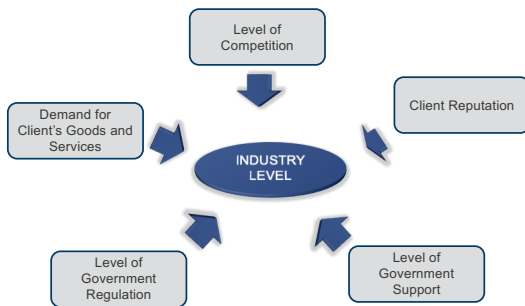


Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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GAINING AN UNDERSTANDING OF A CLIENT

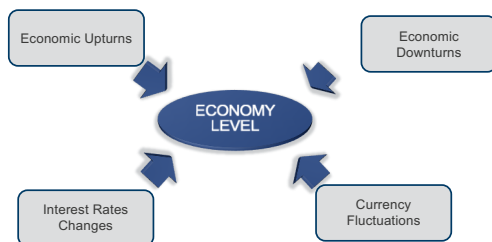


Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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GAINING AN UNDERSTANDING OF A CLIENT



Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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FRAUD RISK

Auditor must assess **risk of material misstatement** due to **fraud** (ISA 240; ISA 240)

Auditor adopts attitude of **professional scepticism**

- Maintaining an **independent questioning mind**
- Search thoroughly for **corroborating evidence** to **validate information** provided by the client
- **Don't just rely on past experience** with client

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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FRAUD RISK

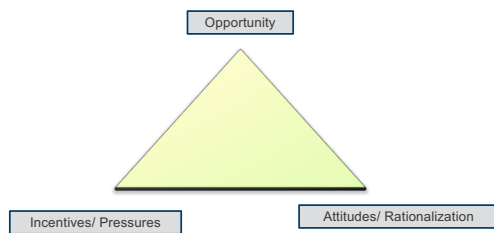
INDICATORS (RED FLAGS) OF POSSIBLE FRAUD:

- **High turnover** of key employees
- **Key finance personnel** refusing to take leave
- Overly **dominant management**
- **Poor compensation** practices
- Inadequate **training programs**
- Complex **business structure**
- No, or ineffective, **internal audit**
- High turnover of **auditors**
- **Unusual transactions**
- Weak **internal controls**

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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FRAUD TRIANGLE



Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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FRAUD RISK

TWO TYPES OF FRAUD:

Financial reporting fraud

- Improper asset values, unrecorded liabilities
- Delaying expenses, bringing forward revenues
- Fictitious revenues, understating expenses
- Inappropriate application of accounting principles

Misappropriation of assets fraud

- Using company credit card for personal items
- Failure to remove ex-employees from payroll
- Unauthorised discounts or refunds to customers
- Theft of stock or other assets

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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GOING CONCERN RISK

- Auditor must consider whether it is appropriate to assume that client will remain a **going concern** (ASA 570; ISA 570)
- Going concern **justifies valuing assets on basis they will continue to be used in business and liabilities paid when due**
- Remaining a going concern is the **responsibility of the client**
- Auditor must obtain **sufficient appropriate evidence** to assess validity of going concern assumption
- Auditor makes **professional judgement** about going concern risk, based on risk indicators

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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GOING CONCERN RISK

ASA 570; ISA 570 has **list of going concern risk indicators**, examples include:

- Significant debt/equity ratio
- Long term loans due, no alternative finance
- Prolonged losses, inability to pay debts when due
- Loss of significant customer, supplier problems
- High staff turnover, loss of key personnel, strikes
- Problems of obtaining raw materials, inputs
- Poor growth planning, inadequate risk management
- Being under investigation for non-compliance
- Competitive pressures, drought etc.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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GOING CONCERN RISK

- Auditor is required to **assess client efforts** to identify going concern risk factors
- Auditor should **obtain evidence** of effect of risk factors on client and its ability to continue as going concern
- **If going concern is in doubt, undertake additional audit procedures**
 - ❑ Assess cash flow, revenues, expenses, interim results
 - ❑ Review debt contracts, board meeting minutes
 - ❑ Discussions with client management and lawyers

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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GOING CONCERN RISK

- Auditor should also consider **factors that mitigate (reduce) going concern risk** such as:
 - ❑ Letter of guarantee from parent company
 - ❑ Availability of assets or segment of business for sale for cash
 - ❑ Ability to raise funds through share issue or borrowing
- Consider adequacy of **client disclosures** in financial report about going concern issues

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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CORPORATE GOVERNANCE

Corporate governance is the **rules, systems and processes** within companies used to guide and control activities

- Used to monitor actions of staff and assess level of risk faced
- Controls used to reduce identified risks and ensure future viability of the company

ASX principles and recommendations for listed companies

- Companies required to disclose their compliance
- 'if not, why not?'

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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IT ENVIRONMENT

- Auditor should consider **particular risks faced by client related to IT** (ASA 315; ISA 315), for example:
 - ❑ **Unauthorised access to computers, software, data**
 - Need security, passwords to prevent distorted data
 - ❑ **Errors in programs**
 - Can occur if not thoroughly tested before implementation, or mistakes made when changing programs
 - Restrict program change rights to authorised personnel
 - Programs need to be suitable for client requirements
 - ❑ **Lack of backup and loss of data**
- Client should have appropriate IT installation and security procedures, and training for staff

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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CLOSING PROCEDURES

- Client closes accounts when preparing financial reports at year-end
 - ❑ **Revenue and expense accounts should include all transactions for the year, and none that relate to other periods**
 - ❑ **Accrued assets and liabilities should be complete**
 - ❑ **Assets and liabilities should include all relevant items**
- Auditor faces risk that client closing procedures are inadequate

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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CLOSING PROCEDURES

Audit procedures to assess adequacy of client closing procedures:

- **Assess adequacy of client interim reporting procedures**
- **Check accuracy of accrual calculations**
- **Analyse results to assess reasonableness**
- **Consider pressures on client to overstate profit or report smoothed income**
- **Trace transactions around year-end to documents to determine appropriate dates**

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

Joe Hales is an audit partner at Faff and Irwin, a medium sized accounting firm that provides assurance and consulting services. Mark Thompson is the Chief Executive Officer (CEO) of a listed internet service company, Netware Inc. Netware's auditor has just resigned and Mark has approached Joe Hales regarding the audit of Netware Inc.

Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

Please consider the following issues when answering the questions provided below:

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.), Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

- i. A few weeks after being asked to conduct the audit of Netware Inc. Joe Hales approached Mark Thompson requesting permission to contact the previous auditor. Mark rejected Joe's request. Mark argued that Netware Inc. has been keeping appropriate financial records and the previous year's audit report was unqualified and unmodified.

(a)	(b)

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.), Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

- ii. Joe has been an auditor for almost 20 years. His clients operate mainly in the manufacturing industry; Joe has never audited an internet service company. Joe recently appointed Peter, who has completed a university degree with a major in e-commerce.

(a)	(b)

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

iii. Netware Inc. purchases consulting services from Faff and Irwin.

(a)	(b)

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.). Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

iv. Netware Inc. not only provides internet consultation, but it also provides free software, free music and free movies to individual subscribers. Further, Netware Inc. is going to launch a service that allows individuals to upload any movies their own website for sharing with their friends.

(a)	(b)

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

v. Netware Inc.'s CEO Mark Thompson wants to make sure the financial report is published on time. As this is a new audit for Faff and Irwin, audit partner Joe Hales believes that the audit team needs extra time to complete the audit. This means that Mark's deadline won't be met.

(a)	(b)

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question a: Explain how the situation may impact Joe's decision of whether or not to accept Netware Inc. as a new client of Faff and Irwin.

Question b: With reference to your answer to (a) above, what steps should Joe take before deciding whether or not to accept Netware Inc. as a new client of Faff and Irwin?

- vi. Joe presents Mark with an engagement letter and asks Mark to sign the letter. Mark indicates that an engagement letter is not necessary, as he understands the auditor's duties perfectly.

(a)	(b)

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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