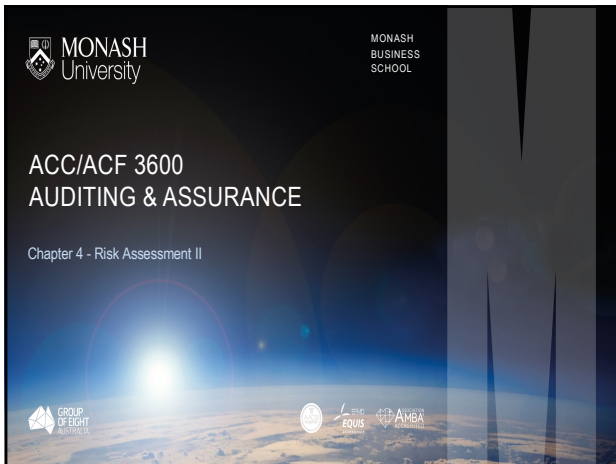




1



LEARNING OBJECTIVES

AFTER READING THIS CHAPTER YOU SHOULD BE ABLE TO:

- 4.1 evaluate **audit risk**
- 4.2 explain the **concept of materiality**
- 4.3 describe how an auditor determines their **audit strategy**
- 4.4 describe how clients **measure performance**
- 4.5 describe how an auditor uses **analytical procedures when assessing risk**.
- 4.6 describe **matters of most significance** in the audit of the financial report of the current period

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

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AUDIT RISK

AUDIT RISK is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated (ASA 200; ISA 200)

This means the auditor gives an opinion that the financial report is true and fair when it contains a significant error or fraud

- **Audit risk can never be zero**
- **Audit risk is reduced during risk response phase by identifying the key risks and adjusting audit effort accordingly**

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

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AUDIT RISK

INHERENT RISK

The susceptibility of an **assertion** to a misstatement that could be material either individually or when aggregated with other misstatements, assuming there are no related controls

Identification of accounts and related assertions **most at risk of material misstatement**.

Assertions are statements made by management about **recognition**, **measurement**, **presentation** and **disclosure** of items in financial report and notes

Examples:

- Inventory items on the balance sheet actually **exist**
- Inventory items are **valued** correctly

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

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AUDIT RISK

INHERENT RISK

Risks are more significant when they involve:

- **Fraud**
- Related to **significant economic or accounting developments**
- **Complex transactions**
- Significant **related party transactions**
- Significant **subjectivity in measurement** of financial information
- Significant **transactions outside the client's normal course of business**

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

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AUDIT RISK

CONTROL RISK

The risk that a client's system of internal controls will not prevent or detect a material misstatement

RISK OF MATERIAL MISSTATEMENT (RMM)

Inherent and control risk combined

Auditor plans to undertake detailed testing of each identified account:

Based on auditor's assessments of riskiness of account and related assertions, and effectiveness of the client's system of internal controls.

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

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AUDIT RISK

DETECTION RISK

The risk that the auditor's testing procedures will not be effective in detecting a material misstatement

Auditor will plan and perform their audit to reduce audit risk to an acceptably low level (ASA 200; ISA 200).

There is an inverse relationship between IR and CR combined (RMM), and DR

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

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AUDIT RISK

Audit risk model

$$AR = f(IR, CR, DR)$$

AR = audit risk

IR = inherent risk

CR = control risk

DR = detection risk

Risk of material misstatement (RMM) existing in client's financial report and at assertion level comprises both IR and CR ($RMM = IR + CR$)

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

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MATERIALITY

- Materiality guides audit planning, testing, and assessment of information in financial report
- Information is material if it impacts on the decision-making process of users of the financial report

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

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MATERIALITY

Qualitative materiality factors

- **Nature** of the item, for example
 - ☐ Fraud
 - ☐ Non-compliance with laws
 - ☐ Related party transactions
 - ☐ Change of accounting methods

Quantitative materiality factors

- **Magnitude** of the item
 - ☐ Express as percentage of relevant base figure
 - ☐ Use professional judgment
 - ☐ Guidelines: > **10% of profit**, **1% of assets**, material

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

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MATERIALITY

- Auditors uses **professional judgement** when setting planning **materiality**.
- **Inverse** relationship between materiality and risk
 - ☐ **Lower materiality % adopted if client is higher risk**
- Setting **lower materiality level** during risk assessment **increases the quality and quantity** of evidence required to be gathered
 - ☐ **More items fall into material category at lower level**
 - ☐ For example, if materiality is set at \$100,000, all items above \$100,000 are material; if materiality is set at \$50,000, all items above \$50,000 are material

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

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MATERIALITY

- During the risk assessment phase the auditor determines a materiality level used throughout their audit testing
- This is a **dollar amount** calculated on a **key number** in the client's financial statements:
 - ☐ **Profit before tax** (do not use if co makes a loss)
 - ☐ **Total assets**
 - ☐ **Equity** (net assets)
 - ☐ **Revenue**
 - ☐ **Cash flows from operating activities**

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

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MATERIALITY

- 5% – 10% of profit before tax
- 0.5% – 1% of assets
- 0.5% – 1% of revenue
- Whether the auditor selects the lower, higher or an in between % will depend on the **RMM** in the entity
 - High RMM, then auditor will have **lower materiality** and **test more items**

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

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Materiality and Audit Risk

$$AR = f(IR, CR, DR)$$

- If **IR** and **CR** are **HIGH** what happens to Materiality?
 - Planning **materiality** will be set **LOW** (i.e. closer to 5% of an appropriate base)
 - There is an **inverse relationship** between RMM and materiality

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

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Materiality and Audit Risk

$$AR = f(IR, CR, DR)$$

- If **IR** and **CR** are **LOW** what happens to Materiality?
 - Planning **materiality** will be set **HIGH** (i.e. closer to 10% of an appropriate base)
 - There is an **inverse relationship** between RMM and materiality

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

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Steps in deciding materiality

1. Assess **inherent risk** (high, medium, low)
2. Assess **control risk** (high, medium, low)
3. Determine **detection risk** (high, medium, low)
4. Determine **appropriate base**
5. Set **materiality %** based on level of detection risk
6. Calculate **\$ value of materiality**

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

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AUDIT STRATEGY

Auditors must establish an **overall audit strategy** (ASA 300; ISA 300)

- Sets **scope, timing, and direction** of the audit
- Provides basis for developing detailed audit plan
- Is based on preliminary assessments of **IR** and **CR**

Audit risk = f	Inherent risk	Control risk	Detection risk
	High	High	Low
Audit strategy	No (or very limited) tests of controls		Increased reliance on substantive tests of transactions and account balances

Note: The items in italics are determined by the auditor.

Audit risk = f	Inherent risk	Control risk	Detection risk
	Low	Low	High
Audit strategy	Increased reliance on tests of controls		Reduced reliance on substantive tests of transactions and account balances

Note: The items in italics are determined by the auditor.

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

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CLIENT PERFORMANCE MEASURES

As part of gaining an understanding of the client, the auditor should learn **how their client measures its own performance**

- Client uses **key performance indicators (KPIs)** to monitor and assess its performance and staff performance, and KPIs can be written into contracts between client and others
- Auditor needs to understand **what client focuses on**, and **what is potentially at risk of misstatement**

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

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CLIENT PERFORMANCE MEASURES

PROFITABILITY

- Profit by division, branch, manager etc.
- Price earnings ratio (P/E)
- Earnings per share (EPS)
 - ❑ Decline could signal pressure on management
- Cash Earning per share (CEPS)
- Inventory turnover
 - ❑ Decline could signal overvalued stock

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

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CLIENT PERFORMANCE MEASURES

LIQUIDITY

- Ability of company to meet its cash needs in short and long term
- Ratios can be written into debt contracts (as covenants) and restrict client's actions
- Client potentially under pressure to misstate accounts included in ratios

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

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ANALYTICAL PROCEDURES

- Evaluation of financial information by studying plausible links among both financial and non-financial data (ASA 520; ISA 520)
- Identify fluctuations in accounts that are inconsistent with auditor's expectations based on their understanding of the client

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

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ANALYTICAL PROCEDURES

Analytical procedures can be conducted throughout audit

- Risk assessment phase – risk identification
- Risk response phase – estimating account balances
- Reporting – overall review

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

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ANALYTICAL PROCEDURES

SIMPLE COMPARISONS

- Account balance with previous year, budget

TREND ANALYSIS (HORIZONTAL ANALYSIS)

- Comparison of account balances over time
- Select base year, restate all accounts in subsequent years as a % of that base

For both techniques, the auditor should factor in client and economic changes, and form expectations of reasonable changes in balances over time

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

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ANALYTICAL PROCEDURES

COMMON-SIZE ANALYSIS (VERTICAL ANALYSIS)

- Comparison of account balances to single line item
- Balance sheet – express each item as % of total assets
- Income statement – express each item as % of sales
- Using analysis over several years, auditor can see how each account contributes to totals, and how this changes over time

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

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ANALYTICAL PROCEDURES

RATIO ANALYSIS

- Assess **relationship** between various financial report **balances**, and between them and **non-financial items**
 - Profitability ratios
 - Liquidity ratios
 - Solvency ratios

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

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ANALYTICAL PROCEDURES

FACTORS TO CONSIDER WHEN CONDUCTING ANALYTICAL PROCEDURES

- Has client data been **audited**? Is external data **reliable**?
- Poor **controls** would signal higher risk in relying on analytical procedures
- Change in **accounting methods** could distort data
- Auditor may have access to **half-year results** only
- Reliability of **budget setting process** – is client continually missing budgeted targets?
- Are **industry comparisons** valid?

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

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Communicating Key Audit Matters (KAM) in the Independent Auditor's Report (ASA 701)

Determining Key Audit Matters

- Areas of higher assessed risk of material misstatement
- Significant auditor judgements
- Effect on the audit of significant events or transactions

❑ Not a Substitute for Expressing a Modified Opinion

Adapted from ASA 701

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KAM – Example from the AMP Limited Annual Report 2017

Valuation of complex and illiquid financial investments

Why significant

Investments in financial assets total \$136,675 million and represent 92% of total assets.

As set out in Note 2.5, the portfolio of investments is categorised in accordance with the fair value hierarchy, as required by accounting standards. The complex and illiquid investments are typically classified as Level 3 investments, where there is a lack of observable market transactions and available market data.

The Group exercised judgement to arrive at their best estimates of fair value of these assets. There is complexity in this process, as well as risk associated with the valuation and modelling methodologies and the assumptions adopted.

How our audit addressed the key audit matter

Our audit procedures included the following:

- We assessed the Group's controls over the valuation of illiquid financial investments.
- For all level 3 investments, where relevant, our valuation specialists assessed the valuation and modelling methodologies and the key assumptions used, including the prevailing local market conditions for offshore assets, for the year end valuations.
- For assets recorded within controlled unit trusts where there are no specific local reporting requirements, we assessed the valuations of investments on a sample basis as provided by external investment managers, including an assessment of the reliability of the information provided by the investment managers.

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Question 1

ABC Company is one of the biggest 10 companies. It operates in several industries, including banking, computer, medicine and cloths manufacturing industries. It has offices around the world to support its operation, including China, United States, England, South Africa, Japan, and Korea. Its customers come from many different countries and it also has frequent international transactions with its subsidiaries.

Question a: In the above case, which audit risk factor is addressed?

Question b: In your opinion, what's the appropriate level of detection risk?

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Question 2

The following is the pre-audited financial information of ABC Company from 2014 to 2017.

Question: Use analytical procedures and identify risky accounts.

Account	2014	2015	2016	2017
Revenue	\$1000	\$2000	\$4000	\$8000
COGS	\$500	\$1200	\$3000	\$5000
Profit	\$500	\$800	\$1000	\$3000
Other Expense	\$200	\$400	\$500	\$600
Operating Income	\$300	\$400	\$500	\$2400

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Question 3

Cheap-as-Chips stocks thousands of items that range in value from \$1 to \$100. The inventory on hand represents a material portion of current assets. The merchandise items change according to the season and the promotional theme adopted by the stores' management for the year. Merchandise is ordered up to four months in advance from Chinese and Korean suppliers. These special orders require Cheap-as-Chips to give the suppliers substantial deposits upon placement of the orders.

Question: What are the inherent risks for Cheap-as-Chips' inventory?
Discuss the assertions being made by management about the inventory.

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

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