# CPA专业方向师资培训 —— Day 6

## Morning Session

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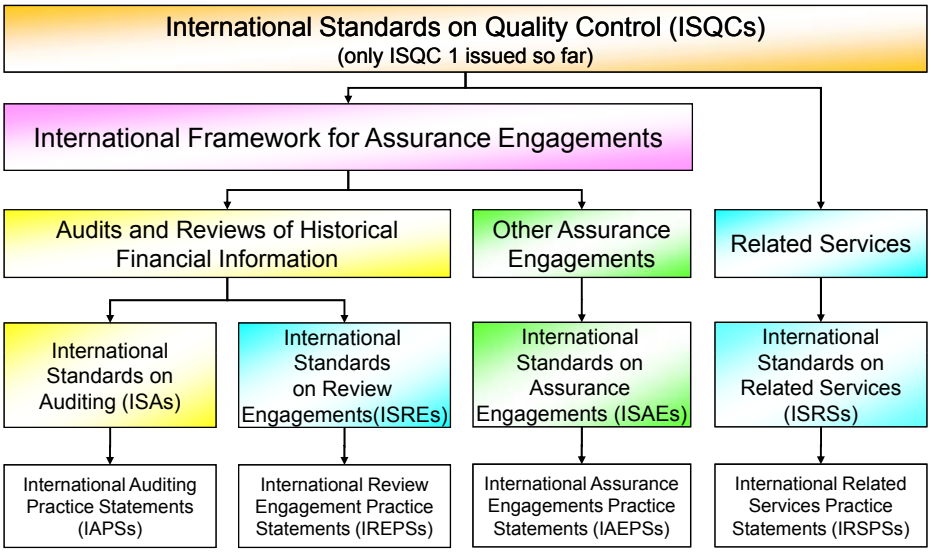
# Overview

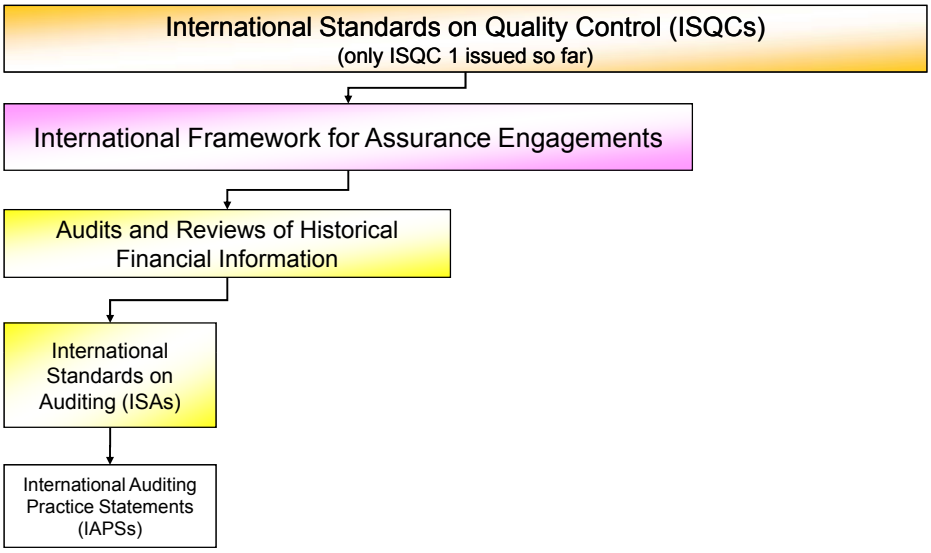
- PRC Auditing standards was converged to International Auditing Standards in 2006
  - Become part of the standards under standards on quality control, auditing, assurance and related services
- Critical points
  - Firm-wide standard issued (ISQC): not only applicable to audit but also other assurance and related services
  - Revised planning and risk assessment approach
  - More correlation between assessed risks with audit procedures

# Overview



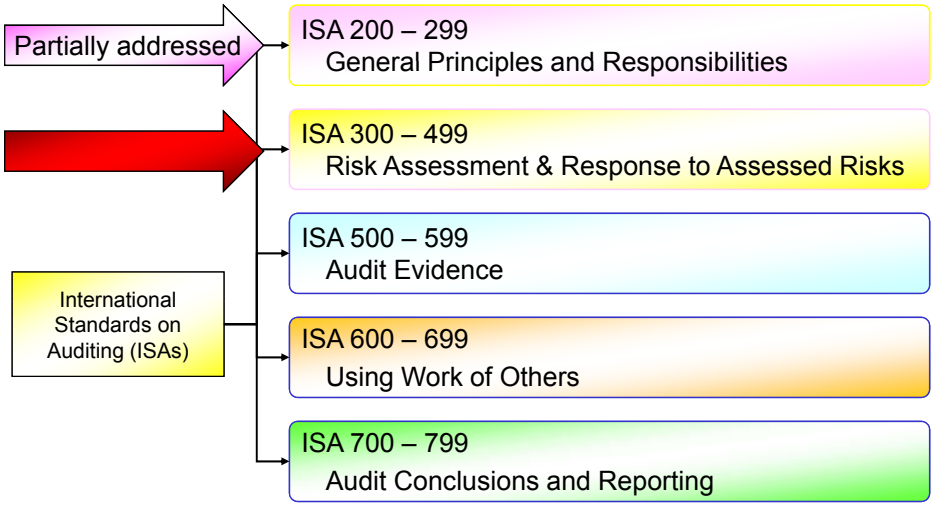

 

# Overview



# Overview



# Overview

**One of the Critical Requirements in our Audit**

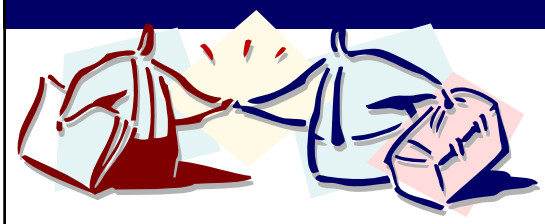
ISA 300 – 499
Risk Assessment & Response to Assessed Risks

Our focus today:

- ISA 300 Planning an Audit of Financial Statements
- ISA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
- ISA 320 Audit Materiality
- ISA 330 The Auditor's Procedures in Response to Assessed Risks

# Today's Agenda



Planning an Audit of Financial Statements (ISA 300)

Understanding the Entity and its Environment (ISA 315)

Assessing the Risks of Material Misstatement (ISA 315)

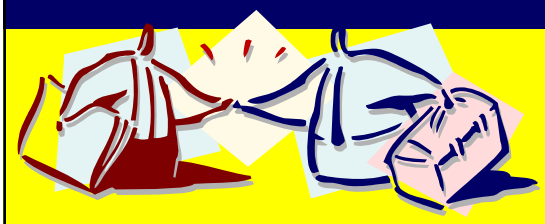
**Simple but Comprehensive**

**Critical and New Issues**

**Templates and Examples**




# Today's Agenda



Planning an Audit of Financial Statements (ISA 300)

# Planning an Audit

- ISA 300 specifically requires that:
  - The auditor should plan the audit so that the engagement will be performed in an effective manner. (ISA 300.2)
- The issues involved are:
  - What should be involved in such a plan?
  - What should be the nature, timing and extent of such plan?
  - What are the benefits in planning the audit?




# Planning – Benefits

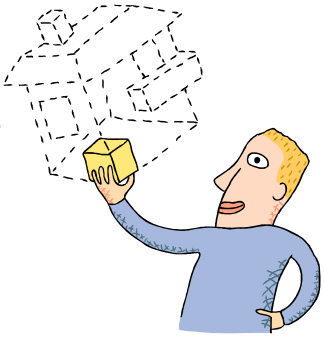
- Adequate planning can have the following benefits:
  - appropriate attention is devoted to important areas of the audit
  - potential problems are identified and resolved on a timely basis
  - the audit engagement is properly organized and managed in order to be performed in an effective and efficient manner
  - assisting the proper assignment of work to engagement team members
  - 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 involves
  - the engagement partner and other key members of the engagement team
    - to benefit from their experience and insight and
    - to enhance the effectiveness and efficiency of the planning process.

# Planning – Nature, Extent & Timing

Refer to Case

- **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?**

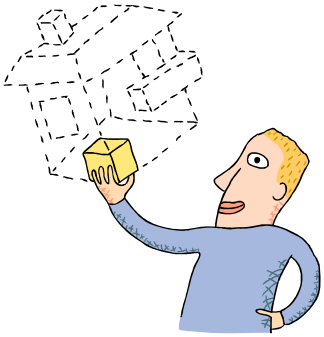




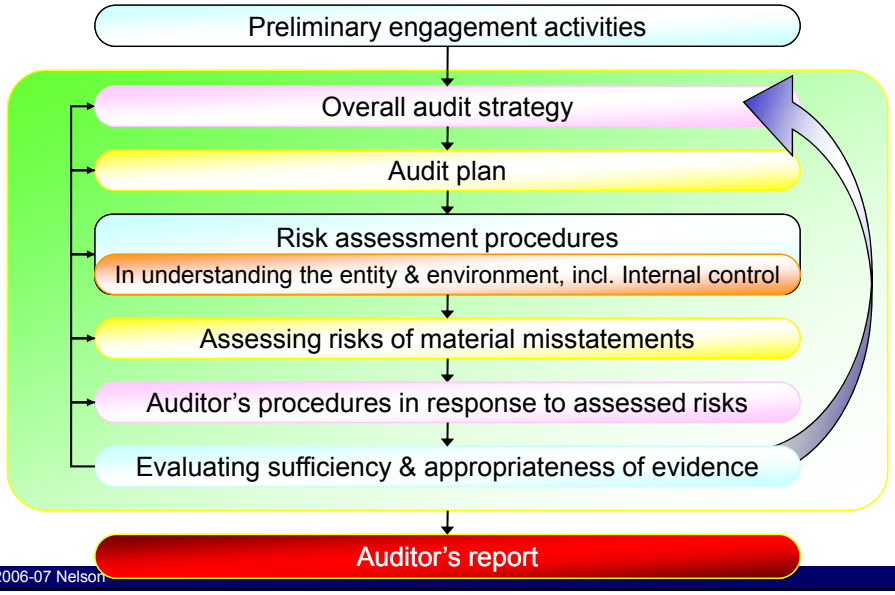

# Planning – Overview

ISA 300 Planning an Audit of Financial Statements

1. Preliminary engagement activities
2. Planning activities
3. Additional considerations in initial audit engagement



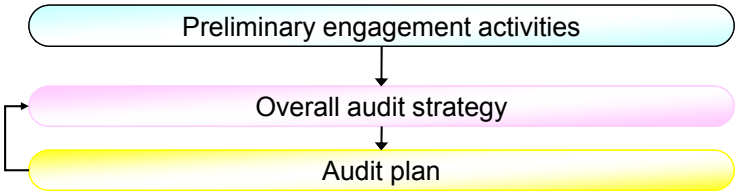
# Planning – Audit Process Overview







# Planning – Audit Process Overview

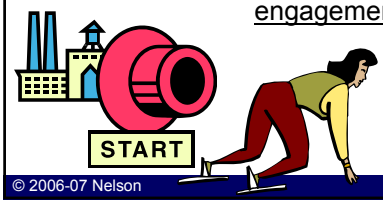


# Preliminary Engagement Activities

ISA 300 Planning an Audit of Financial Statements

Preliminary Engagement Activities

- The auditor should perform the following activities at the beginning of the current audit engagement: (ISA 300.6)
  1. Perform procedures regarding the continuance of the client relationship and the specific audit engagement
  2. Evaluate compliance with ethical requirements, including independence
  3. Establish an understanding of the terms of the engagement



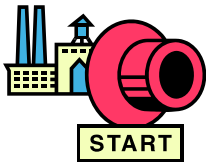

 

# Preliminary Engagement Activities

ISA 300 Planning an Audit of Financial Statements

Preliminary Engagement Activities

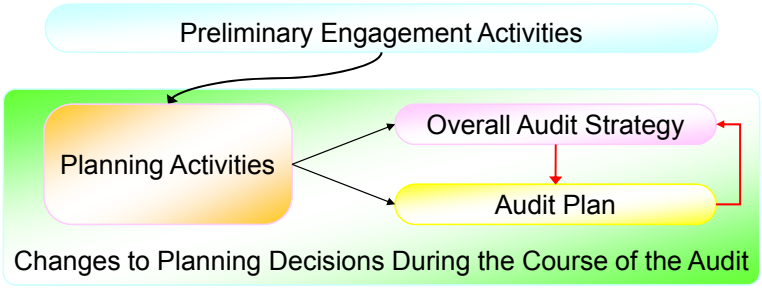
- Performing preliminary engagement activities helps ensure that
  - the auditor has considered any events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level.
  - the auditor plans an audit engagement for which:
    - 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

ISA 300 Planning an Audit of Financial Statements




- The auditor should establish and document
  - Overall audit strategy for the audit and
  - Audit plan for the audit in order to reduce audit risk to an acceptably low level.
- Both the overall audit strategy and audit plan should be updated and changed as necessary during the course of the audit.

# Planning – Overall Audit Strategy

- ISA 300 specifically requires that:
  - The auditor should establish the overall audit strategy for the audit (ISA 300.8)
- The overall audit strategy
  - sets the scope, timing and direction of the audit, and
  - guides the development of the more detailed audit plan.

Overall Audit Strategy

# Planning – Overall Audit Strategy

- The establishment of the overall audit strategy involves:
  a) Determining the characteristics of the engagement that define its scope
  b) Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
  c) Considering the important factors that will determine the focus of the engagement team's efforts

Overall Audit Strategy




# Planning – Overall Audit Strategy

**Example**

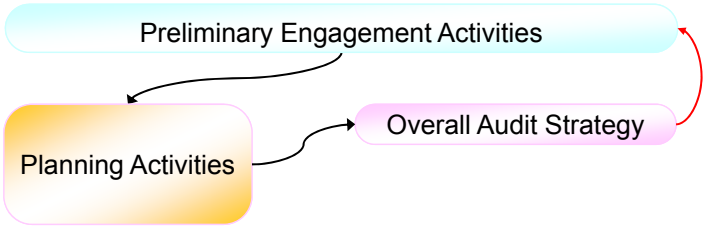
- The establishment of the overall audit strategy involves:
  a) Determining the characteristics of the engagement that define its scope
  b) Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
  c) Considering the important factors that will determine the focus of the engagement team's efforts

- 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 – Overall Audit Strategy

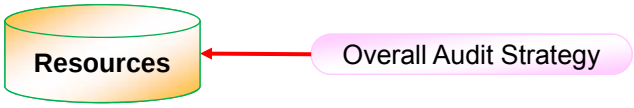



- In developing the overall audit strategy, the auditor also considers
  - the results of preliminary engagement activities and,
  - where practicable, experience gained on other engagements performed for the entity.




# Planning – Overall Audit Strategy

- The process of developing the overall audit strategy helps the auditor to ascertain the nature, timing and extent of resources necessary to perform the engagement.




- In response to the matters identified (and subject to any updates and changes), the overall audit strategy sets out clearly:
  a) The resources to deploy for specific audit areas
  b) The amount of resources to allocate to specific audit areas
  c) When these resources are deployed
  d) How such resources are managed, directed and supervised

# Planning – Overall Audit Strategy

**Example**

a) The resources to deploy for specific audit areas
   - the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters

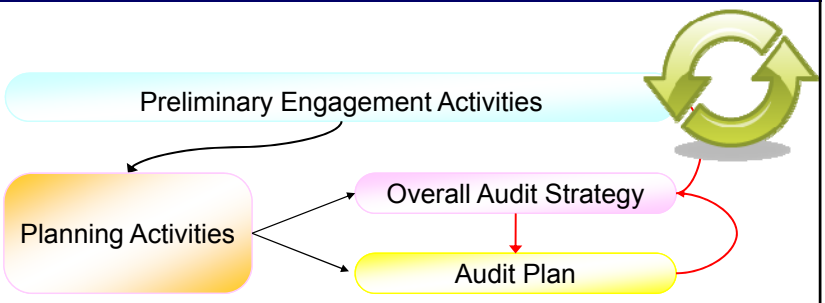
b) The amount of resources to allocate to specific audit areas
   - the number of team members assigned to observe the inventory count at material locations
   - the extent of review of other auditors' work in the case of group audits, or
   - the audit budget in hours to allocate to high risk areas;

c) When these resources are deployed
   - whether at an interim audit stage or at key cut-off dates

d) How such resources are managed, directed and supervised
   - when team briefing and debriefing meetings are expected to be held
   - how engagement partner and manager reviews are expected to take place (for example, on-site or off-site)
   - whether to complete engagement quality control reviews




# From Strategy to Audit Plan




- Once the overall audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the overall audit strategy.
- Although the auditor ordinarily establishes the overall audit strategy before developing the detailed audit plan, the two planning activities
  - are not necessarily discrete or sequential processes
  - but are closely inter-related since changes in one may result in consequential changes to the other.

# Planning – Audit Plan

- The auditor should develop **an audit plan** for the audit in order to reduce audit risk to an acceptably low level. (ISA 300.13)
- The audit plan
  - is more detailed than the audit strategy and
  - includes:
    - A description of the nature, timing and extent of **planned risk assessment procedures** sufficient to assess the risks of material misstatements (as determined under ISA 315)
    - A description of the nature, timing and extent of **planned further audit procedures at the assertion level** for each material class of transactions, account balance and disclosures (as determined under ISA 330)
    - Such **other audit procedures** required to be carried out for the engagement in order to comply with ISAs

Audit Plan

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.

In addition, the auditor may begin the execution of further audit procedures for some areas before completing the more detailed audit plan of all remaining further audit procedures.

Audit Plan

Risk Assessment Procedures

Further Audit Procedures

Other Audit Procedures

# Planning – Audit Plan

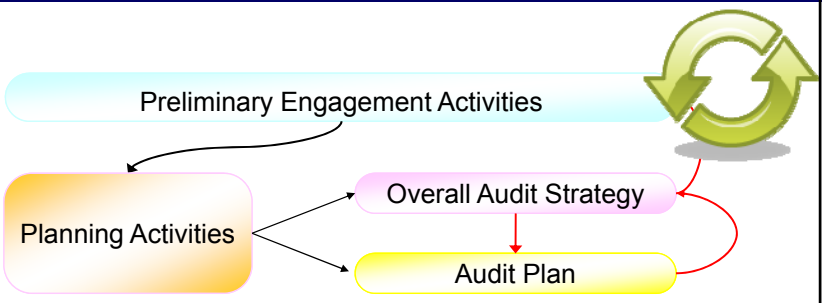
**Example**

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

- 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

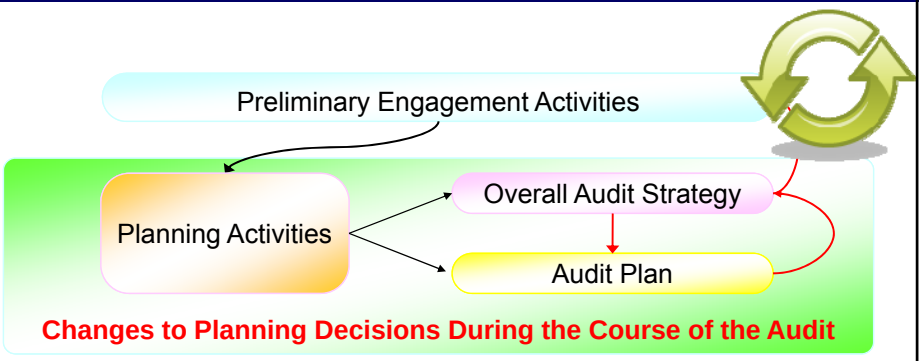



# Planning – Continual and Iterative




- Planning is not a discrete phase of an audit, but rather **a continual and iterative process** 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




- The planning activities, and during the course of an audit, should include a process of update and changes since ISA 300 requires that:
  - The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit. (ISA 300.16)

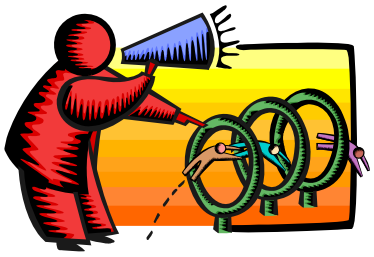
# Planning – Continual and Iterative

**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 to modify the overall audit strategy and audit plan, and
  - thereby the resulting planned nature, timing and extent of further audit procedures.
- 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 Activities



- The auditor should
  - plan the nature, timing and extent of direction and supervision of engagement team members and review of their work. (ISA 300.18)
  - document the overall audit strategy and the audit plan
    - including any significant changes made during the audit engagement. (ISA 300.13)




# Considerations in an Initial Audit

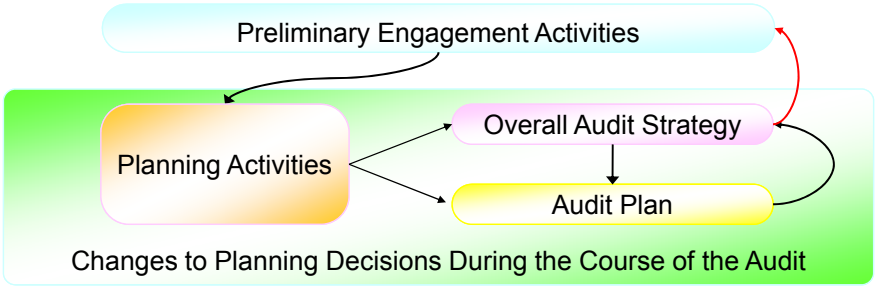
- The auditor should perform the following activities prior to starting an initial audit:
  a) Perform procedures regarding the acceptance of the client relationship and the specific audit engagement (see ISA).
  b) Communicate with the previous auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

# Considerations in an Initial Audit

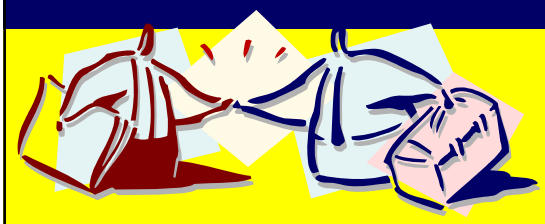

- For initial audits, additional matters the auditor may consider in developing the overall audit strategy and audit plan include the following:
  - Arrangements to be made with the previous auditor, e.g. to review the previous auditor's working papers.
  - Any major issues discussed with management in connection with the initial selection as auditors, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan
  - The planned audit procedures to obtain sufficient appropriate audit evidence regarding opening balances
  - The assignment of firm personnel with appropriate levels of capabilities and competence
  - Other procedures required by the firm's system of quality control for initial audit engagements




# Planning an Audit



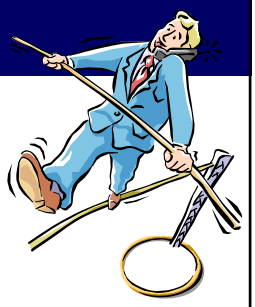

# Today's Agenda



Understanding the Entity and its Environment (ISA 315)




# Purpose of ISA 315



- ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*
  - One of the critical requirements in ISAs
  - Its purpose is to establish standards and to provide guidance
    - on obtaining an understanding of the entity and its environment, including its internal control, and
    - on assessing the risks of material misstatement in a financial statement audit.

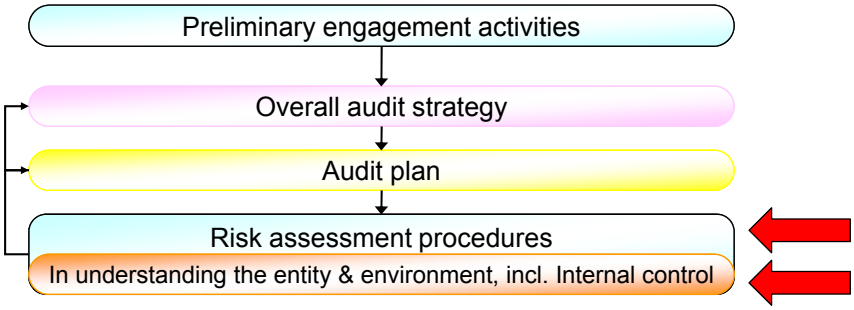
- The auditor should obtain an understanding of the entity and its environment, including its internal control,
  - sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and
  - sufficient to design and perform further audit procedures. (ISA 315.2)

# Purpose of ISA 315

- 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




# Audit Process Overview




1. **Risk Assessment Procedures (and other sources)**
2. **Understanding the Entity and its Environment**

# 1. Risk Assessment Procedures

- Audit procedures to obtain an understanding are referred to as "**risk assessment procedures**"
  - because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement

Risk assessment procedures

In understanding the entity & environment, incl. Internal control

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




# 1. Risk Assessment Procedures

- ISA 315 specifically requires that:
  - The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:
    a) **Inquiries** of management and others within the entity;
    b) **Analytical procedures**; and
    c) **Observation** and **inspection**. (ISA 315.7)

- The auditor is not required to perform all the risk assessment procedures described above for each aspect of the understanding required in ISA 315 (to be discussed)
- All the risk assessment procedures are performed by the auditor in the course of obtaining the required understanding
- Other audit procedures, if helpful, can also be performed.

# 1. Risk Assessment Procedures

- For continuing engagement, when the auditor intends to use information about the entity and its environment obtained in prior periods
  - the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit. (ISA 315.12)
- The members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements. (ISA 315.14)




# 2. Understanding of the Entity

- Risk assessment procedures are used to obtain an understanding of the entity ……

Risk assessment procedures

In understanding the entity & environment, incl. Internal control

| Industry, Regulatory, and Other External Factors | Nature of the Entity | Objectives and Strategies, and Related Business Risks | Measurement and Review of the the Entity's Financial Performance | Internal Control |
|---|---|---|---|---|

# 2. Understanding of the Entity

- The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:
  1. Industry, regulatory, and other external factors, including the applicable financial reporting framework.
  2. Nature of the entity, including the entity's selection and application of accounting policies.
  3. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
  4. Measurement and review of the entity's financial performance.
  5. Internal control.

| Industry, Regulatory, and Other External Factors | Nature of the Entity | Objectives and Strategies, and Related Business Risks | Measurement and Review of the the Entity's Financial Performance | Internal Control |
|---|---|---|---|---|




# 2. Understanding of the Entity

**1. Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework**

– The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (ISA 315.22)

- These factors include
  – industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments;
  – the regulatory environment encompassing, among other matters, the applicable financial reporting framework, the legal and political environment, and environmental requirements affecting the industry and the entity; and
  – other external factors such as general economic conditions.

Industry, Regulatory, and Other External Factors

# 2. Understanding of the Entity

**2. Nature of the Entity**

- The auditor should obtain an understanding of the nature of the entity. (ISA 315.25)
- The nature of the entity refers to
  - the entity's operations,
  - its ownership and governance,
  - the types of investments that it is making and plans to make,
  - the way that the entity is structured and
  - how it is financed.

Nature of the Entity

- An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.




# 2. Understanding of the Entity

**2. Nature of the Entity**

- The auditor should
  - obtain an understanding of the entity's selection and application of accounting policies and
  - consider whether they are
    - appropriate for its business and
    - consistent with the applicable financial reporting framework and accounting polices used in the relevant industry. (ISA 315.28)

Nature of the Entity

# 2. Understanding of the Entity

**3. Objectives and Strategies and Related Business Risks**

- The auditor should obtain an understanding of
  - the entity's objectives and strategies, and
  - the related business risks that may result in material misstatement of the financial statements. (ISA 315.30)
    - Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies

Objectives and Strategies, and Related Business Risks




# 2. Understanding of the Entity

**4. Measurement and Review of the Entity's Financial Performance**

- The auditor should obtain an understanding of
  - the measurement and review of the entity's financial performance.
    - Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements.
    - Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

Measurement and Review of the the Entity's Financial Performance

# 2. Understanding of the Entity

**5. Internal Control**

- The auditor should obtain an understanding of
  - internal control relevant to the audit.
    - The auditor uses the understanding of internal control to
      - identify types of potential misstatements,
      - consider factors that affect the risks of material misstatement, and
      - design the nature, timing, and extent of further audit procedures.

Internal Control




# 2. Understanding of the Entity

**5. Internal Control**

- Ordinarily, controls that are relevant to an audit pertain to
  - the entity's objective of preparing financial statements for external purposes and
  - the management of risk that may give rise to a material misstatement in those financial statements.
- In exercising its judgment whether a control is relevant to the audit, the auditor considers :
  - The auditor's judgment about materiality.
  - The size of the entity.
  - The nature of the entity's business.
  - The diversity and complexity of the entity's operations.
  - Applicable legal and regulatory requirements.
  - The nature and complexity of the systems that are part of the entity's internal control

Internal Control

# 2. Understanding of the Entity

**Focus on the requirements in ISA 315**

5. **Internal Control**
   - An entity's internal control consists of the following components :

**The Control Environment**

**The Entity's Risk Assessment Process**

**The Information System**

**Control Activities**

**Monitoring of Controls**

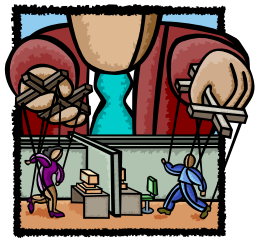
Internal Control




# 2. Understanding of the Entity

**The Control Environment**
- obtain an understanding of the control environment. (ISA 315.67)

**The Entity's Risk Assessment Process**
- obtain an understanding the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof. (ISA 315.76)



Internal Control

# 2. Understanding of the Entity

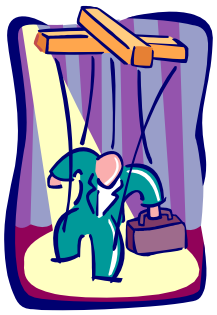
– The auditor should understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. (ISA 315.89)

**The Information System**

- obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:
  - The classes of transactions that are significant to the financial statements
  - The procedures (IT and manual) by which those transactions are initiated, recorded, processed and reported
  - The related accounting records (electronic or manual), supporting information, and specific accounts in respect of the above procedures
  - How the information system captures events and conditions that are significant to the financial statements.
  - The financial reporting process used to prepare the entity's financial statements (ISA 315.81)



# 2. Understanding of the Entity



**Control Activities**

- The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks. (ISA 315.90)
- The auditor should obtain an understanding of how the entity has responded to risks arising from IT. (ISA 315.93)

# 2. Understanding of the Entity

**Monitoring of Controls**

- The auditor should obtain an understanding of the major types of 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 corrective actions to its controls. (ISA 315.96)




# 2. Understanding of the Entity

Risk assessment procedures

In understanding the entity & environment, incl. Internal control

- Industry, Regulatory, and Other External Factors
- Nature of the Entity
- Objectives and Strategies, and Related Business Risks
- Measurement and Review of the the Entity's Financial Performance
- Internal Control

# 2. Understanding of the Entity

Risk assessment procedures

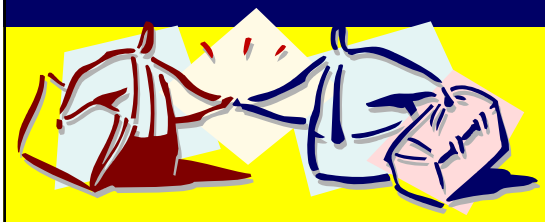
In understanding the entity & environment, incl. Internal control

↓

Assessing risks of material misstatements




# Today's Agenda



Assessing the Risks of Material Misstatement (ISA 315)

# Assessing the Risks

Preliminary engagement activities

↓

Overall audit strategy

↓

Audit plan

↓

Risk assessment procedures

In understanding the entity & environment, incl. Internal control

↓

Assessing risks of material misstatements




# What is Audit Risk?

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

  - ISA 200 "*Objective and General Principles Governing an Audit Of Financial Statements*" describes that

    "Audit risk" is a function of

    - the risk of material misstatement of the financial statements (or simply, the "**risk of material misstatement**")
      - i.e., the risk that the financial statements are materially misstated prior to audit, and
    - the risk that the auditor will not detect such misstatement ("**detection risk**").

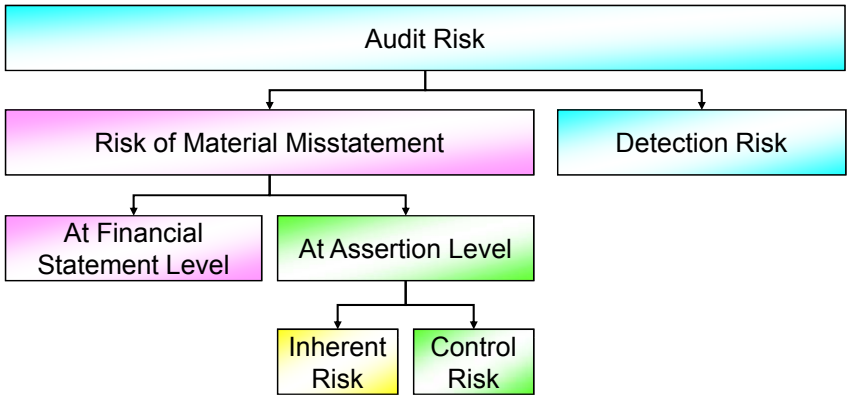
# Assessing the Risks


ISA 200 further clarifies that

- the auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole.
- In order to design audit procedures to determine whether there are misstatements that are material to the financial statements taken as a whole, the auditor considers the risk of material misstatement at two levels:
  - the overall financial statement level and
  - in relation to classes of transactions, account balances, and disclosures and the related assertions.

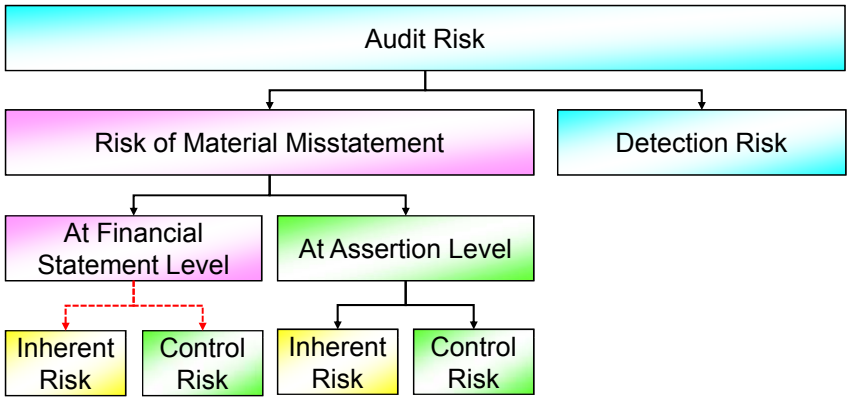



# Assessing the Risks




- The risk of material misstatement at the assertion level consists of two components:
  1. Inherent risk
  2. Control risk

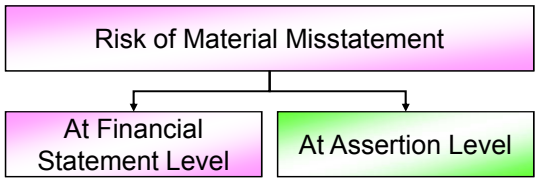
# Assessing the Risks




- 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.

# Assessing the Risks




ISA 315 requires that

- The auditor should <u>identify</u> and <u>assess</u> the <u>risks of material misstatement</u>
  - <u>at the financial statement level</u>, and
  - <u>at the assertion level</u> for classes of transactions, account balances, and disclosures (ISA 315.100)

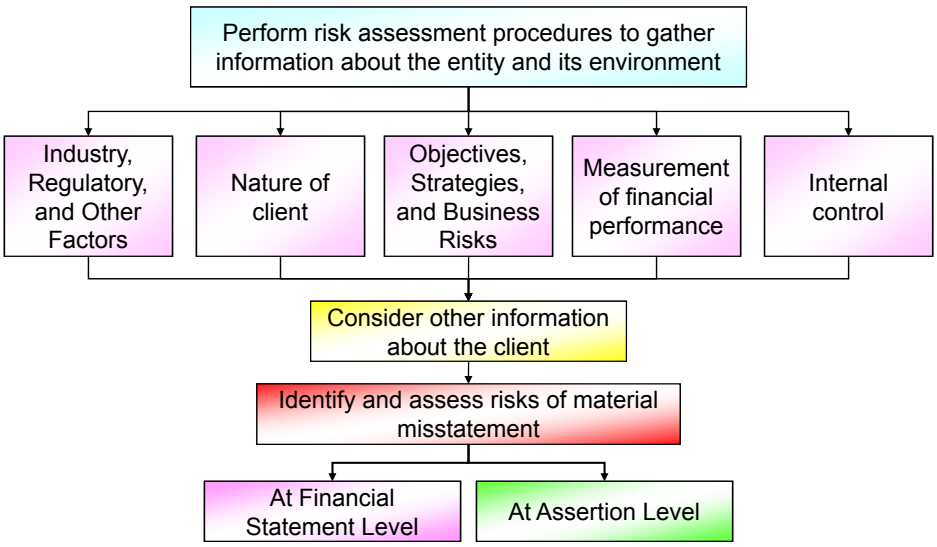
 

# Assessing the Risks

- For the purpose of assessing the risks, the auditor:
  - Identifies 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;
  - Relates the identified risks to what can go wrong at the assertion level;
  - Considers whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and
  - Considers the likelihood that the risks could result in a material misstatement of the financial statements.




# Assessing the Risks

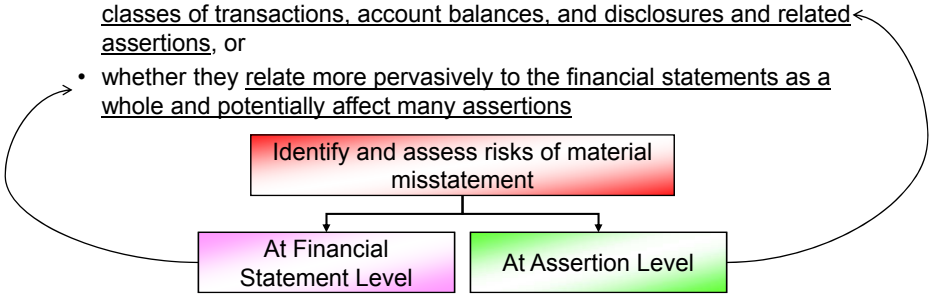




*Adapted from Audit Guide of AICPA*

# Assessing the Risks

- The auditor uses information gathered by performing risk assessment procedures as audit evidence to support the risk assessment, and
  - in turn, uses the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.
- The auditor determines
  - whether the identified risks of material misstatement relate to specific classes of transactions, account balances, and disclosures and related assertions, or
  - whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions







# Risks at Financial Statement Level

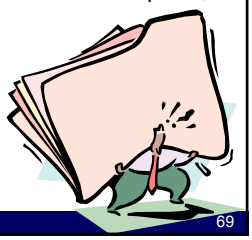
- The risk of material misstatement at the overall financial statement level
  - refers to risks of material misstatement that
    - relate pervasively to the financial statements as a whole and
    - potentially affect many assertions.
- Risks of this nature
  - often relate to the entity's control environment , say weak control environment (although these risks may also relate to other factors, such as declining economic conditions), and
  - are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.

At Financial Statement Level

# Risks at Financial Statement Level

- The overall financial statement risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions,
  - for example, through management override of internal control.
- Such risks may be especially relevant to the auditor's consideration of the risk of material misstatement arising from fraud.
- The auditor's response to the assessed risk of material misstatement at the overall financial statement level includes
  - consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts;
  - the appropriate levels of supervision; and
  - whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

At Financial Statement Level



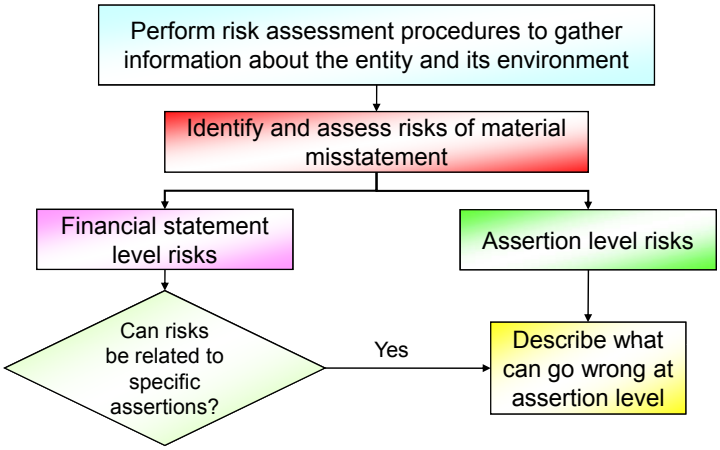



# Risks at Assertion Level

- The risk of material misstatement at the assertion level consists of two components as follows:
  - "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.
  - "Control risk" is the risk that a misstatement that could occur in an assertion 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.
    - That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements.
    - Some control risk will always exist because of the inherent limitations of internal control.

At Assertion Level

# Assessing the Risks



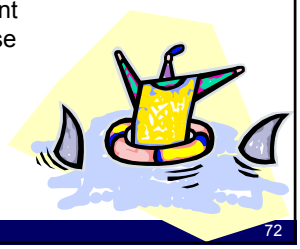




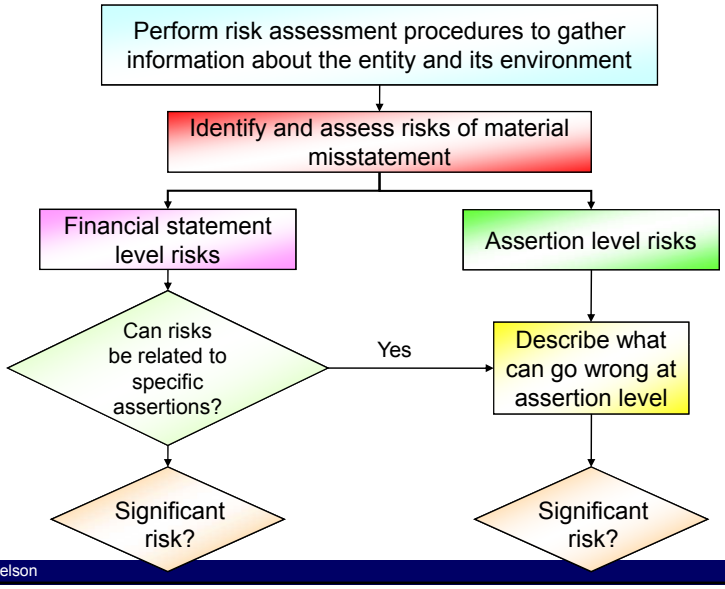
# Determine Significant Risks

- As part of the risk assessment, the auditor should determine
  - which of the risks identified are, in the auditor's judgment, risks that require special audit consideration
  - such risks are defined as "**significant risks**". (ISA 315.108)
- The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment.
  - In exercising this judgment, the auditor excludes the effect of identified controls related to the risk to determine whether
    - the nature of the risk,
    - the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and
    - the likelihood of the risk occurring

    are such that they require special audit consideration.



# Determine Significant Risks



# Determine Significant Risks

- Significant risks are often derived from business risks that may result in a material misstatement. In considering the nature of the risks, the auditor considers a number of matters, including the following:
  - Whether the risk is a risk of fraud.
  - Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
  - The complexity of transactions.
  - Whether the risk involves significant transactions with related parties.
- Significant risks often relate to significant **non-routine transactions** and **judgmental matters**.
  - **Non-routine transactions** are transactions that are unusual, either due to size or nature, and that therefore occur infrequently.
  - **Judgmental matters** may include the development of accounting estimates for which there is significant measurement uncertainty.

# Determine 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.




# Determine Significant Risks

- For significant risks, to the extent the auditor has not already done so, the auditor should
  - evaluate the design of the entity's related controls, including relevant control activities, and
  - determine whether they have been implemented. (ISA 315.113)
- An understanding of the entity's controls related to significant risks is required to provide the auditor with adequate information to develop an effective audit approach.
- Management ought to be aware of significant risks; however, risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls.

Significant risk?

Significant risk?

# Determine Other Risks

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

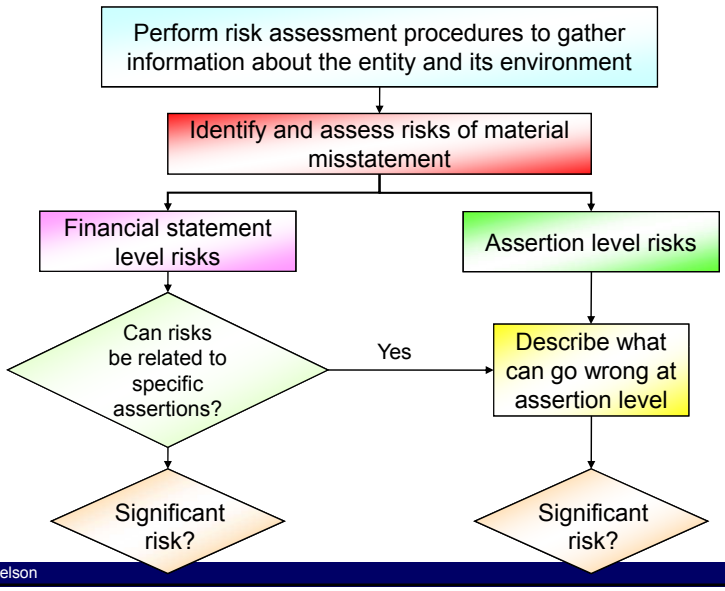
- As part of the risk assessment, the auditor should
  - evaluate the design and
  - determine the implementation of the entity's controls, including relevant control activities, over those risks
    - for which, in the auditor's judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. (ISA 315.115)

**Any examples?**

- Ordinarily, such risks relate to significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

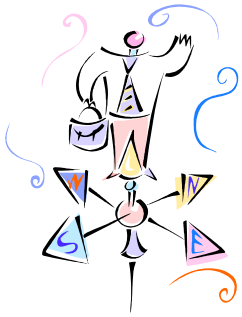



# Assessing the Risks



# Revision of Risk Assessment

- The auditor's assessment of the risks of material misstatement at the assertion level
  - is based on available audit evidence and
  - may change during the course of the audit as additional audit evidence is obtained.






# Communication

- Communicating with Those Charged with Governance and Management
  - The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention. (ISA 315.120)

# Documentation

- The auditor should document:
  a) The discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;
  b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment (identified in ISA 315.20), including each of the internal control components (identified in ISA 315.43), to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;
  c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion; and
  d) The risks identified and related controls evaluated as a result of the requirements in respect of significant risks and risks for which substantive procedures alone do not provide sufficient appropriate audit evidence




# CPA专业方向师资培训 —— Day 6

## Morning Session

20 August 2007

Full version of the slides can be found in
**www.NelsonCPA.com.hk**

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# CPA专业方向师资培训 —— Day 6

## Afternoon Session

20 August 2007

Nelson Lam 林智遠
MBA MSc BBA ACA CFA CPA(Aust)
CPA(US) FCCA FCPA(Practising) MSCA

# Overview

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




# Today's Agenda

- Communication of Audit Matters with Those Charged with Governance (ISA 260)
- Audit Materiality (ISA 320)
- The Auditor's Procedures in Response to Assessed Risks (ISA 330)

Simple but Comprehensive

Critical and New Issues

Templates and Examples

# Today's Agenda

Communication of Audit Matters with Those Charged with Governance (ISA 260)




# The Requirements of IAS 260

- The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. (ISA 260.2)

Audit Matters of Governance Interest

Those Charged with Governance

- The questions are:
  - Who are those charged with governance?
  - What are audit matters of governance interest?

# The Requirements of IAS 260

Audit Matters of Governance Interest

- For the purpose of ISA 260, "Audit matters of governance interest" are those that
  - arise from the audit of financial statements and,
  - in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process.
- They include only those matters that have come to the attention of the auditor as a result of the performance of the audit.
  - The auditor is not required, in an audit in accordance with ISAs, to design audit procedures for the specific purpose of identifying matters of governance interest.




# The Requirements of IAS 260

- For the purpose of ISA 260, "governance" is the term used
  - to describe the role of persons entrusted with the supervision, control and direction of an entity.
- Those charged with governance
  - ordinarily are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties
  - include management only when it performs such functions.

Those Charged with Governance

# Relevant Persons

- ISA 260 requires that:
  - The auditor should determine the **relevant persons**
    - who are charged with governance and
    - with whom audit matters of governance interest are communicated. (ISA 260.5)
- The structures of governance vary from country to country reflecting cultural and legal backgrounds, for example
  - Some places have a supervisory (non-executive board) and management (executive) board
  - Some places have a single, unitary board
- Difficult to establish a universal identification of such relevant persons

Those Charged with Governance




# Relevant Persons

**Example**

The relevant persons may be ……

Those Charged with Governance

- The structures of governance vary from country to country reflecting cultural and legal backgrounds, for example
  - Some places have a supervisory (non-executive board) and management (executive) board
  - Some places have a single, unitary board
- Difficult to establish a universal identification of such relevant persons

**The supervisory board**

**The whole board**

# Relevant Persons

- To avoid misunderstandings, **an audit engagement letter** may explain
  - that the auditor will communicate only those matters of governance interest that come to attention as a result of the performance of an audit and
  - that the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

Those Charged with Governance

The engagement letter may also:
- Describe the form in which any communications on audit matters of governance interest will be made;
- Identify the relevant persons with whom such communications will be made; and
- Identify any specific audit matters of governance interest which it has been agreed are to be communicated.




# Audit Matter of Governance Interest

Audit Matters of Governance Interest

- The auditor should
  - consider audit matters of governance interest that arise from the audit of the financial statements and
  - communicate them with those charged with governance. (ISA 260.11)

## Audit Matter of Governance Interest

**Example**

List some examples of audit matters of governance interest.

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements.
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements.
- The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.
- Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial statements.
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.




## Audit Matter of Governance Interest

**Example**

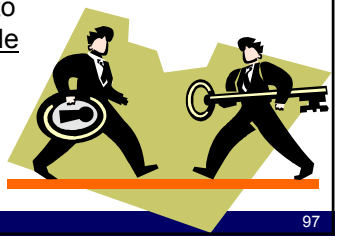
List some examples of audit matters of governance interest.

- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter.
- Expected modifications to the auditor's report.
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.
- Any other matters agreed upon in the terms of the audit engagement.

# Audit Matter of Governance Interest

Audit Matters of Governance Interest

- The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (ISA 260.11a)
- The uncorrected misstatement communicated to those charged with governance need not include the misstatement below a designated amount.





# Timing and Forms

- The auditor should communicate audit matters of governance interest on a timely basis. (ISA 260.13)
- This enables those charged with governance to take appropriate action.

Audit Matters of Governance Interest

Those Charged with Governance

- The auditor's communications with those charged with governance may be made orally or in writing.
  - initially discuss the matters with management, except those relate to management's competence or integrity
  - need not repeat the communications with those charged with governance if
  - management agrees to communicate the matters to them and
  - the auditors are satisfied that such communications have effectively and appropriately been made

# Other Matters

- If the auditor considers that a modification of the auditor's report on the financial statements is required, as described in ISA 701, "Modifications to the Independent Auditor's Report," communications between the auditor and those charged with governance cannot be regarded as a substitute.
- The auditor considers whether audit matters of governance interest previously communicated may have an effect on the current year's financial statements.
- The auditor considers whether the point continues to be a matter of governance interest and whether to communicate the matter again with those charged with governance.

Audit Matters of Governance Interest

Those Charged with Governance




# Today's Agenda

Audit Materiality (ISA 320)

# Materiality

- The auditor should consider
  - **materiality** and
  - **its relationship with audit risk**

  when conducting an audit. (ISA 320.2)

**What is material?**

- IAS 1 *Presentation of Financial Statements* define that information is material if:
  - Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
  - Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful. (IAS 1.11)




# Materiality

- Materiality is not only an issue in auditing but also an issue in financial reporting.
  - The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (ISA 320.4)
- The assessment of what is material is a matter of professional judgment.

# Materiality

- In designing the audit plan,
  - the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements.
- However, both the amount (quantity) and nature (quality) of misstatements need to be considered.




# Materiality

Example

- List examples of qualitative misstatements that should be considered.

- Examples of qualitative misstatements
  - Inadequate or improper description of an accounting policy
    - when it is likely that a user of the financial statements would be misled by the description, and
  - Failure to disclose the breach of regulatory requirements
    - when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

# Role of Materiality

- The auditor should consider materiality when
  a. determining the nature, timing and extent of audit procedures, and
  b. evaluating the effect of misstatements. (ISA 320.8)

- **Materiality limit** is useful to the auditor in 3 main areas:
  a. As a guide to audit planning.
  b. As a guide to the evaluation of audit results and the formation of the audit opinion.
  c. As a means for dealing with a number of insignificant errors that could add up to a large amount.




# Planning Materiality

- **Planning materiality** is such materiality level determined early in the audit for planning purposes.
  - For tests of control
    - planning materiality is used to determine the maximum level of deviations from important internal controls that can be tolerated without reducing the planned reliance on these controls.
  - For analytical procedures
    - planning materiality is used to determine what is a significant deviation from anticipated results so that more audit work will be performed to follow up the deviations.
  - For other substantive procedures
    - planning materiality is used to determine the sample size of the procedures.

# Planning Materiality

- Factors determining planning materiality include:
  a. Sensitivity of financial statement readers to the accuracy of the financial statements,
  b. Practical availability of the required amount of evidence within the constraints of cost, timeliness and availability.
  c. Overall risk of the client, as indicated by prior years' experience, nature of the business, etc.
  d. Materiality guidelines issued by accounting bodies.
  e. Professional judgement to decide what is material in a particular situation.




# Materiality and Audit Risks

- The relationship between materiality and audit risk
  - Understanding of the entity and its environment establishes a frame of reference.
  - Inverse relationship between materiality and the level of audit risk.
  - The higher the materiality level the lower the audit risk is, and vice versa.

# Materiality and Audit Risks

Misstatement still important even amount is less than materiality limit

- Equity accounts, say share capital
- Fraud or irregularity
- Change in earning trend
- Violating statutory requirements

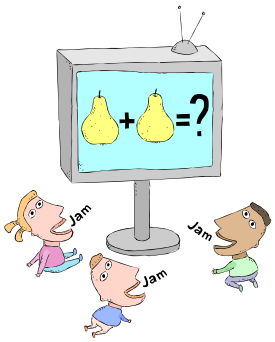



# Materiality and Audit Risks

- The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures.
- **Evaluation materiality** refers to the revised planning materiality level
  - Modified due to
    - changes in circumstances raised during the audit or
    - changes in the auditor's knowledge as a result of the audit

# Evaluating the Misstatement Effect

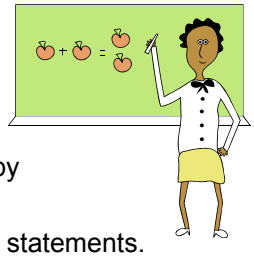
- In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework,
  - ➢ the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material. (ISA 320.12)
- The aggregate of uncorrected misstatements comprises:
  a) **Specific misstatements identified** by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and
  b) The auditor's best estimate of other misstatements which cannot be specifically identified (i.e. **projected errors**).



# Evaluating the Misstatement Effect

- The auditor needs to consider whether the aggregate of uncorrected misstatements is material.
- If the auditor concludes that the misstatements may be material,
  - ➢ the auditor needs to consider reducing audit risk by
    - extending audit procedures or
    - requesting management to adjust the financial statements.

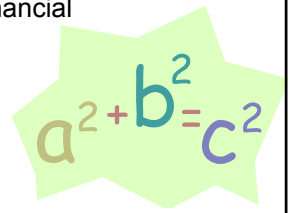


- If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider
  - – the appropriate modification to the auditor's report in accordance with ISA 701 *Modifications to the Independent Auditor's Report*. (ISA 320.15)

# Evaluating the Misstatement Effect

- If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level,
  - the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level.
- Thus, as aggregate uncorrected misstatements approach the materiality level
  - the auditor would consider reducing audit risk
    - by performing additional audit procedures or
    - by requesting management to adjust the financial statements for identified misstatements.



# Communication of Errors

- If the auditor has identified a material misstatement resulting from error,
  - the auditor should
    - communicate the misstatement to the appropriate level of management on a timely basis, and
    - consider the need to report it to those charged with governance in accordance with ISA 260, *Communication of Audit Matters to Those Charged with Governance*. (ISA 320.17)

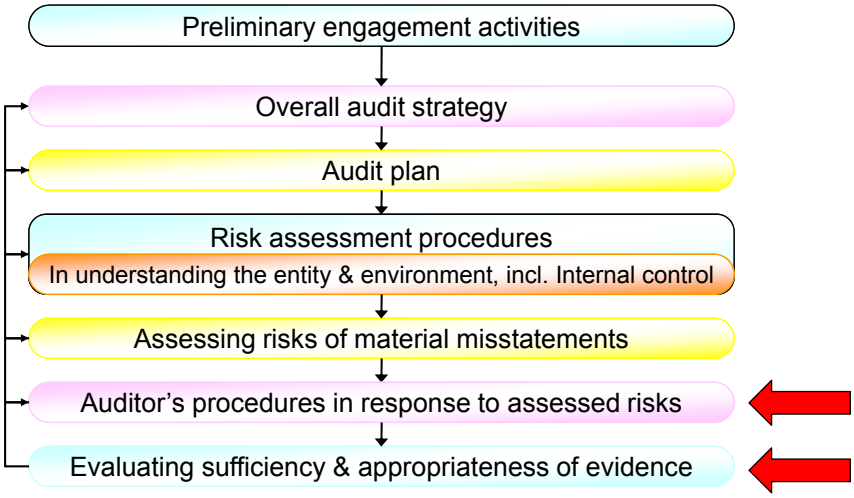
 

# Today's Agenda

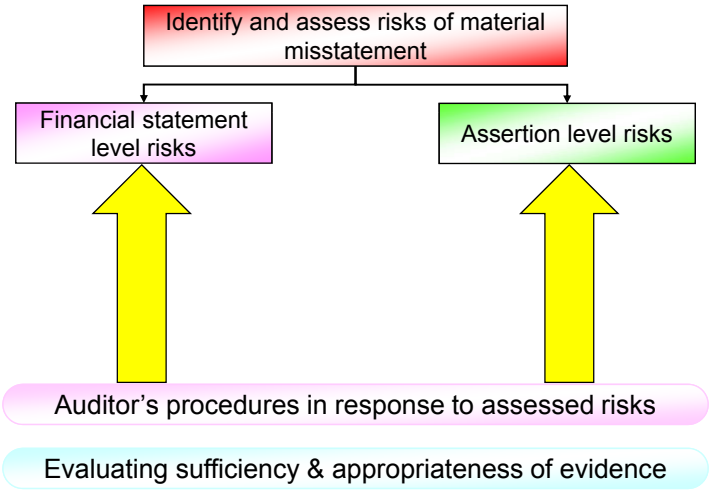
The Auditor's Procedures in Response to Assessed Risks (ISA 330)




# Audit Process Overview

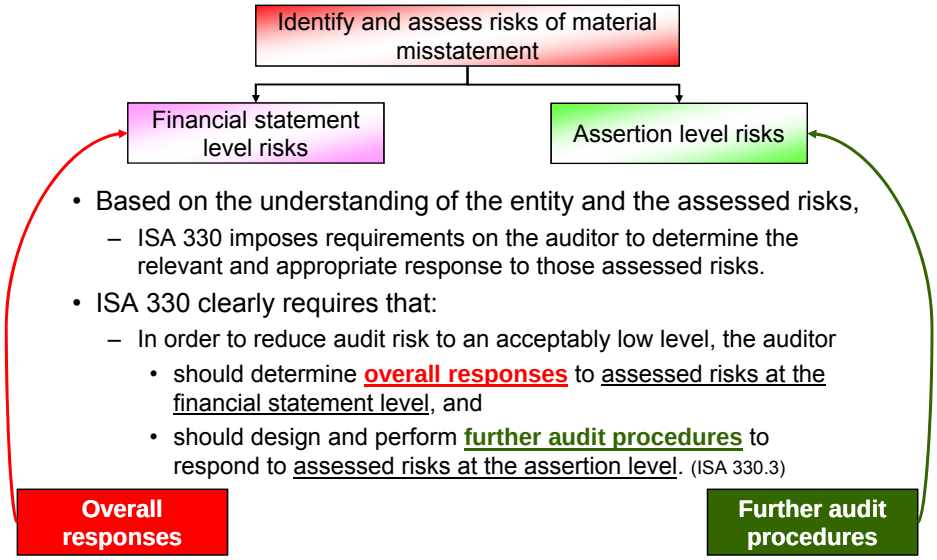


# Responses to Assessed Risks



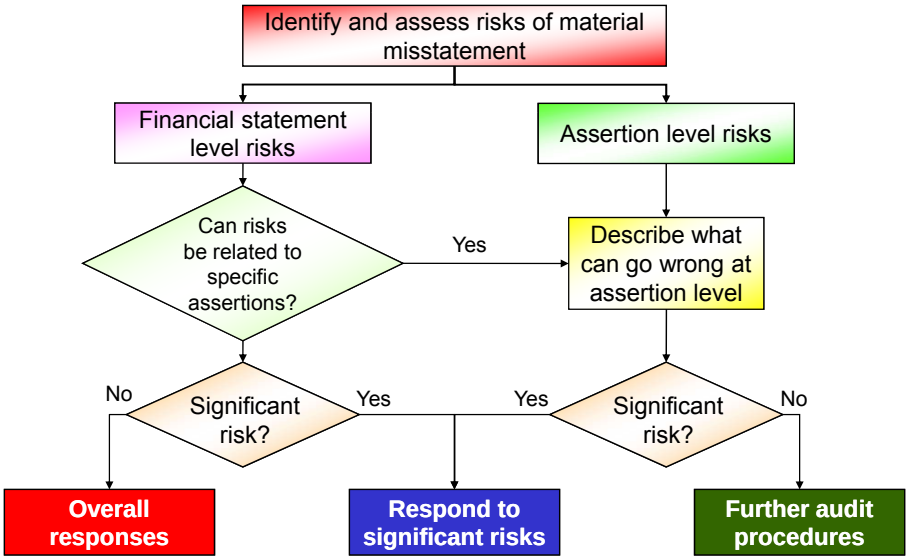
# Responses to Assessed Risks




- Based on the understanding of the entity and the assessed risks,
  - ISA 330 imposes requirements on the auditor to determine the relevant and appropriate response to those assessed risks.
- ISA 330 clearly requires that:
  - In order to reduce audit risk to an acceptably low level, the auditor
    - should determine **overall responses** to assessed risks at the financial statement level, and
    - should design and perform **further audit procedures** to respond to assessed risks at the assertion level. (ISA 330.3)

# Responses to Assessed Risks






# Overall Responses

- The auditor should determine **Overall Responses** to address the risks of material misstatement at the financial statement level. (ISA 330.4)

  - Overall responses may include:
    - emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence,
    - assigning more experienced staff or those with special skills or using experts,
    - providing more supervision, or
    - incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
    - making general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

**Overall responses**

# Overall Responses

- The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment.
  - An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example,
    - allow the auditor to conduct some audit procedures at an interim date rather than at period end.

Overall responses




# Overall Responses

Example

- If there are weaknesses in the control environment, how would they affect the auditor's overall response?

- If there are weaknesses in the control environment, the auditor ordinarily
  - conducts more audit procedures as of the period end rather than at an interim date,
  - seeks more extensive audit evidence from substantive procedures,
  - modifies the nature of audit procedures to obtain more persuasive audit evidence, or
  - increases the number of locations to be included in the audit scope.
- It may also have a significant bearing on the auditor's general approach, for example,
  - an emphasis on substantive procedures (**substantive approach**), or
  - an approach that uses tests of controls as well as substantive procedures (**combined approach**).

Ov
resp

# Further Audit Procedures (FAP)

- The auditor should design and perform **further audit procedures** whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. (ISA 300.7)
  - The purpose is to provide a clear linkage between
    - the nature, timing, and extent of the auditor's further audit procedures and
    - the risk assessment.

Nature

Timing

Extent

**Further audit procedures**




# Further Audit Procedures (FAP)

- In designing further audit procedures, the auditor considers such matters as the following:
  - The significance of the risk.
  - The likelihood that a material misstatement will occur.
  - The characteristics of the class of transactions, account balance, or disclosure involved.
  - The nature of the specific controls used by the entity and in particular whether they are manual or automated.
  - Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting, material misstatements.
- The nature of the audit procedures
  - is of most importance in responding to the assessed risks.

Nature

Timing

Extent

**Further audit procedures**

# Further Audit Procedures (FAP)

- The auditor's assessment of the identified risks at the assertion level
  - provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.
- Often the auditor may determine that a combined approach is an effective approach, such approach would use
  - tests of the operating effectiveness of controls and
  - substantive procedures.

- In some cases, only performing tests of controls may achieve a good response to the assessed risk at an assertion.
- In other cases, performing only substantive procedures is appropriate for an assertions and the relevant control is not considered in risk assessment (say, no relevant effective controls have been identified or such test of control may be inefficient)

Timing

Extent

Further audit procedures




# Further Audit Procedures (FAP)

- The auditor's assessment of the identified risks at the assertion level

Assessed Risk → Nature

Material class of transactions, account balance and disclosure → Timing

Extent

Further audit procedures

- For each material class of transactions, account balance, and disclosure (irrespective of the approach selected),
  - the auditor should design and perform substantive procedures (as required by ISA 330.49, to be discussed in detail later)

# FAP – Nature, Timing and Extent

The nature, timing and extent of FAPs

- **Nature** refers to their purpose and their type
  - Purpose:
    - tests of controls or substantive procedures
  - Type:
    - inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures
- **Timing** refers to
  - When audit procedures are performance (at interim date, at period end, or after period end), or
  - The period or date to which the audit evidence applies
- **Extent** refers to
  - The quantity of a specific audit performance to be performed

Nature

Timing

Extent

Further audit procedures




# FAP – Nature, Timing and Extent

The higher the auditor's assessment of risk,
- the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures.

Nature

The higher the auditor's assessment of risk,
- the more likely or effective to perform procedures nearer to, or at, the period end rather than at an earlier date, or to perform procedures unannounced or at unpredictable time

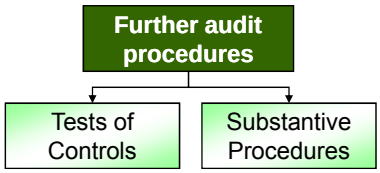
Timing

The higher the auditor's assessment of risk,
- the more quantity of a specific procedure originally performed

Extent

Further audit procedures

# FAP under ISA 330




- FAPs (from the nature perspective) are divided into:
  - Test of controls
  - Substance procedures
- ISA 330 imposes certain requirements on performing these two kinds of procedures

Nature

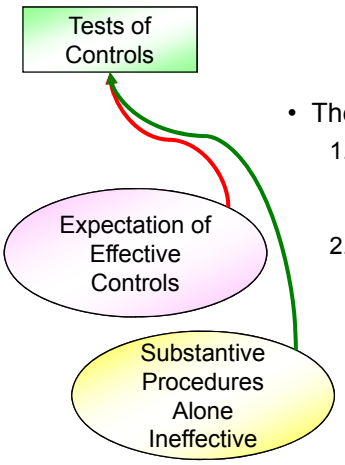
Timing

Extent

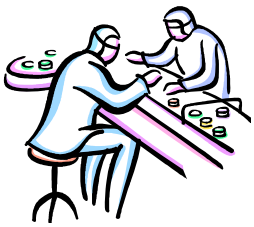
Further audit procedures



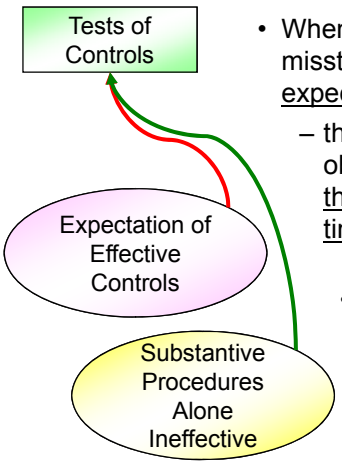

# FAP – Tests of Controls




- The auditor is required to perform tests of controls
  1. when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or
  2. when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.



# FAP – Tests of Controls



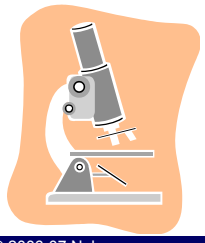

- When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively,
  - the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit. (ISA 330.23)
- When the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures,
  - the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness. (ISA 330.25)




# FAP – Tests of Controls

Tests of Controls

- Testing the operating effectiveness of controls
  - is different from obtaining audit evidence that controls have been implemented.
- When obtaining audit evidence of implementation by performing risk assessment procedures,
  - the auditor determines that the relevant controls exist and that the entity is using them.
- When performing tests of the operating effectiveness of controls,
  - the auditor obtains audit evidence that controls operate effectively, including evidence about
    - how controls were applied at relevant times during the period under audit,
    - the consistency with which they were applied, and
    - by whom or by what means they were applied.



# FAP – Tests of Controls

Tests of Controls

**Nature**

- In respect of the nature of the test of controls, ISA 330 strictly requires that:
  - The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. (ISA 300.29)
- Since inquiry alone is not sufficient, the auditor is requires to use a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls.
  - Those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation.




# FAP – Tests of Controls

**Example**

- For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts.
- Because an observation is pertinent only at the point in time at which it is made, the auditor
  - ordinarily supplements the observation with inquiries of entity personnel, and
  - may also inspect documentation about the operation of such controls at other times during the audit period

  in order to obtain sufficient appropriate audit evidence.

# FAP – Tests of Controls

Tests of Controls

Timing

- The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls.
  - If the auditor tests controls at a particular time,
    - the auditor only obtains audit evidence that the controls operated effectively at that time

      e.g. physical inventory count at period end
  - If the auditor tests controls throughout a period
    - the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period

      e.g. inventory delivery control over the period




# FAP – Tests of Controls

Tests of Controls

Timing

- ISA 330 specifically requires that
  - When the auditor obtains audit evidence about the operating effectiveness of controls <u>during an interim period</u>,
    - the auditor <u>should determine what additional audit evidence should be obtained for the remaining period</u>. (ISA 330.37)
- The auditor obtains audit evidence about the nature and extent of any significant changes in internal control,
  - including changes in the information system, processes, and personnel that occur subsequent to the interim period.

# FAP – Tests of Controls

Tests of Controls

Timing

- ISA 330 also requires that
  - If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits,
    - the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit.
      - by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls. (ISA 330.39)

**Controls Changed** | **Controls Not Changed**




# FAP – Tests of Controls

Tests of Controls

Timing

- ISA 330 requires that
  - If the auditor plans to rely on controls that have changed since they were last tested,
    - the auditor should test the operating effectiveness of such controls in the current audit. (ISA 330.40)
  - If the auditor plans to rely on controls that have not changed since they were last tested,
    - the auditor should test the operating effectiveness of such controls at least once in every third audit. (ISA 330.41)

Test in current audit → **Controls Changed**

**Controls Not Changed** ← Test once every third audit

# FAP – Tests of Controls

Tests of Controls

Timing

- ISA 330 requires that
  - When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits,
    - the auditor should test the operating effectiveness of some controls each audit. (ISA 330.43)

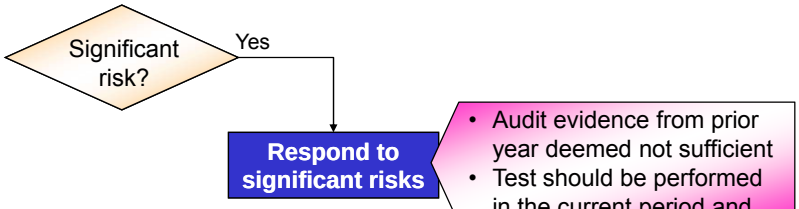



# FAP – Tests of Controls

Tests of Controls

Timing

- ISA 330 requires that
  - When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk,
    - the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. (ISA 330.44)



# FAP – Tests of Controls

Tests of Controls

- The more the auditor relies on the operating effectiveness of controls in the assessment of risk,
  - the greater is the extent of the auditor's tests of controls.

Extent

- In addition, as the rate of expected deviation from a control increases,
  - the auditor increases the extent of testing of the control.
- However, the auditor considers whether the rate of expected deviation indicates that the control will not be sufficient to reduce the risk of material misstatement at the assertion level to that assessed by the auditor.
  - If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective.




# FAP – Substantive Procedures

- Substantive procedures are performed in order to detect material misstatements at the assertion level, and include
  - tests of details of classes of transactions, account balances, and disclosures
  - substantive analytical procedures

**Further audit procedures**

- Tests of Controls
- Substantive Procedures

# FAP – Substantive Procedures

- ISA 330 requires that the auditor always performs substantive procedures for each material class of transactions, account balance, and disclosure:
  - Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (ISA 330.49)
- This requirement reflects the fact that
  - the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.
- Further, there are inherent limitations to internal control including management override.

Substantive Procedures




# FAP – Substantive Procedures

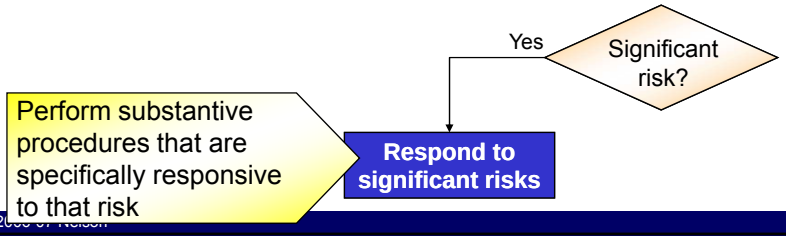
- The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:
  - Agreeing or reconciling the financial statements with to the underlying accounting records; and
  - Examining material journal entries and other adjustments made during the course of preparing the financial statements. (ISA 330.50)

Substantive Procedures

# FAP – Substantive Procedures

- When the auditor has determined that an assessed risk of material misstatement at the assertion level is a **significant risk**,
  - the auditor should perform substantive procedures that are specifically responsive to that risk. (ISA 330.51)

Substantive Procedures






# FAP – Substantive Procedures

**Example**

- The auditor identifies that the management is under pressure to meet earning expectation, discuss any implication on sales and suggest relevant substantive procedures.

- If the auditor identifies that management is under pressure to meet earnings expectations
  - there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment.
- In these circumstances,
  - the auditor may, for example, design external confirmations
    - not only to confirm outstanding amounts,
    - but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms.
  - In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

# FAP – Substantive Procedures

- Substantive analytical procedures
  - are generally more applicable to large volumes of transactions that tend to be predictable over time.
- Tests of details
  - are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances, including existence and valuation.

Substantive Procedures

**Nature**

- In some situations,
  - for example, the auditor may determine that performing only substantive analytical procedures is responsive to the assessed risk of material misstatement for a class of transactions where the auditor's assessment of risk is supported by obtaining audit evidence from performance of tests of the operating effectiveness of controls




# FAP – Substantive Procedures

- ISA 330 specifically requires that:
  - When substantive procedures are performed at an interim date,
    - the auditor should perform
      - further substantive procedures or
      - substantive procedures combined with tests of controls

      to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (ISA 330.56)

Substantive Procedures

**Timing**

- In circumstances where the auditor has identified risks of material misstatement due to fraud,
  - the auditor's response to address those risks may include changing the timing of audit procedures, for example, extending audit procedures from an interim date to the period end.

# FAP – Substantive Procedures

- The greater the risk of material misstatement, the greater the extent of substantive procedures.
  - However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the risk of material misstatement.
  - However, the auditor also considers other matters, including whether it is more effective to use
    - other selective means of testing, such as selecting large or unusual items from a population
    - as opposed to performing
      - representative sampling or
      - stratifying the population into homogeneous subpopulations for sampling.

Substantive Procedures

Extent



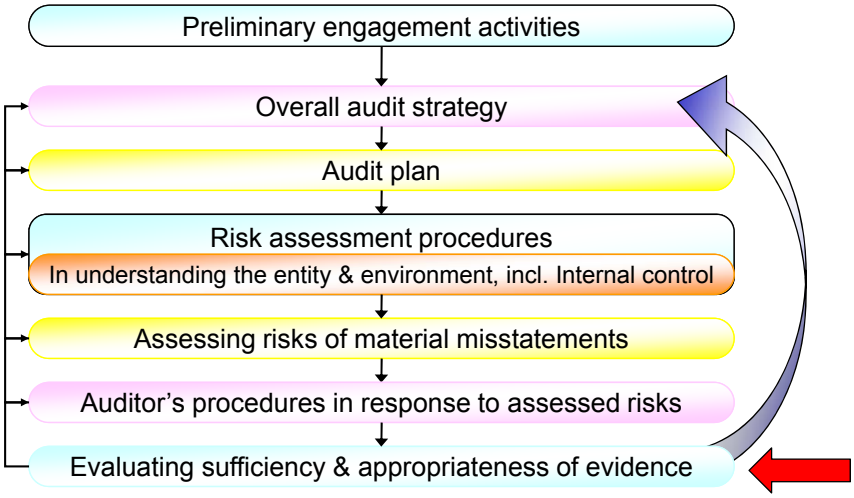

# Presentation and Disclosure

**Adequacy of Presentation and Disclosure**

- ISA 300 requires that:
  - The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework. (ISA 330.65)

Substantive Procedures

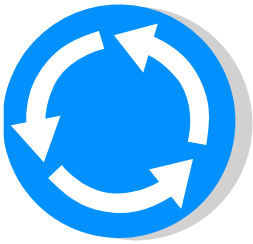
# Audit Process Overview



# Evaluate Sufficiency and Appropriateness

- ISA 300 requires that:
  - Based on the audit procedures performed and the audit evidence obtained,
    - the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (ISA 330.66)



- An audit of financial statements is a cumulative and iterative process.
  - As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures.

# Evaluate Sufficiency and Appropriateness

**Example**

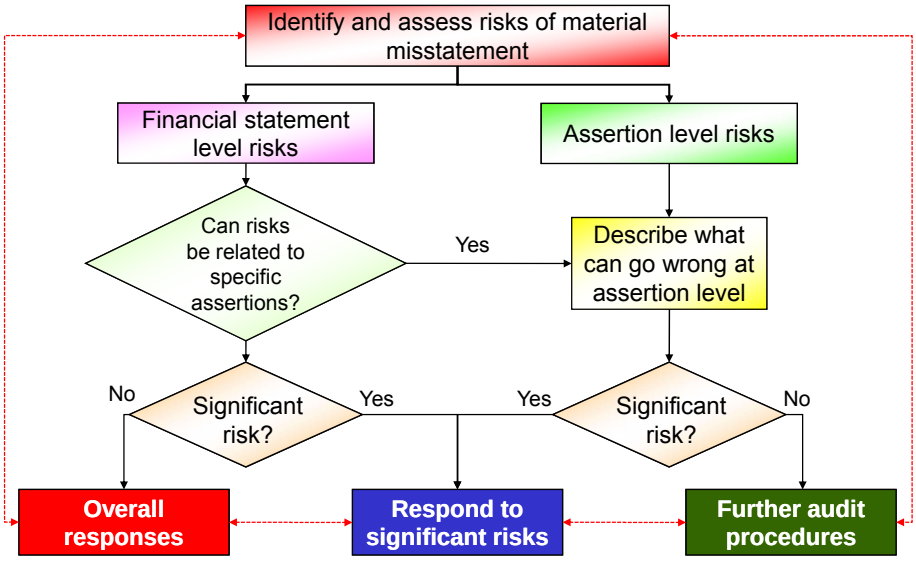
- The extent of misstatements that the auditor detects by performing substantive procedures
  - may alter the auditor's judgment about the risk assessments and
  - may indicate a material weakness in internal control
- Analytical procedures performed at the overall review stage of the audit
  - may indicate a previously unrecognized risk of material misstatement.
- In such circumstances, the auditor may need to reevaluate the planned audit procedures
  - based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.




# Evaluate Sufficiency and Appropriateness

- ISA 300 requires that:
  - The auditor should conclude whether sufficient appropriate audit evidence has been obtained
    - to reduce to an acceptably low level the risk of material misstatement in the financial statements. (ISA 330.70)
  - If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion,
    - the auditor should attempt to obtain further audit evidence.
  - If the auditor is unable to obtain sufficient appropriate audit evidence,
    - the auditor should express
      - a qualified opinion or
      - a disclaimer of opinion. (ISA 330.72)

# Responses to Assessed Risks

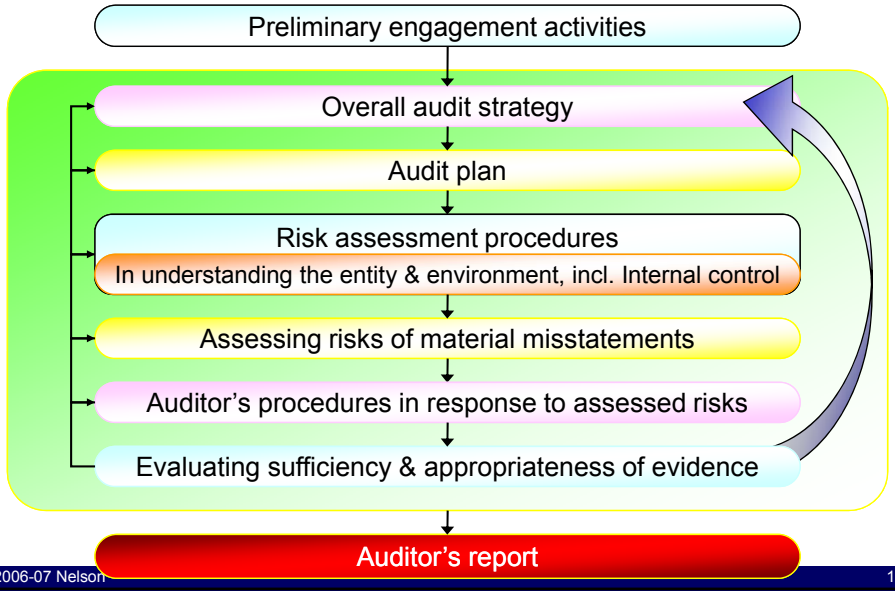





# Documentation

- ISA 300 requires that:
  - The auditor should document
    - the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures,
    - the linkage of those procedures with the assessed risks at the assertion level, and
    - the results of the audit procedures.
  - In addition, if the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document
    - the conclusions reached with regard to relying on such controls that were tested in a prior audit. (ISA 330.73)
  - The auditor's documentation should demonstrate that the financial statements agree or reconcile with the underlying accounting records. (ISA 330.73a)

# Audit Process Overview







# Issues for Assessment

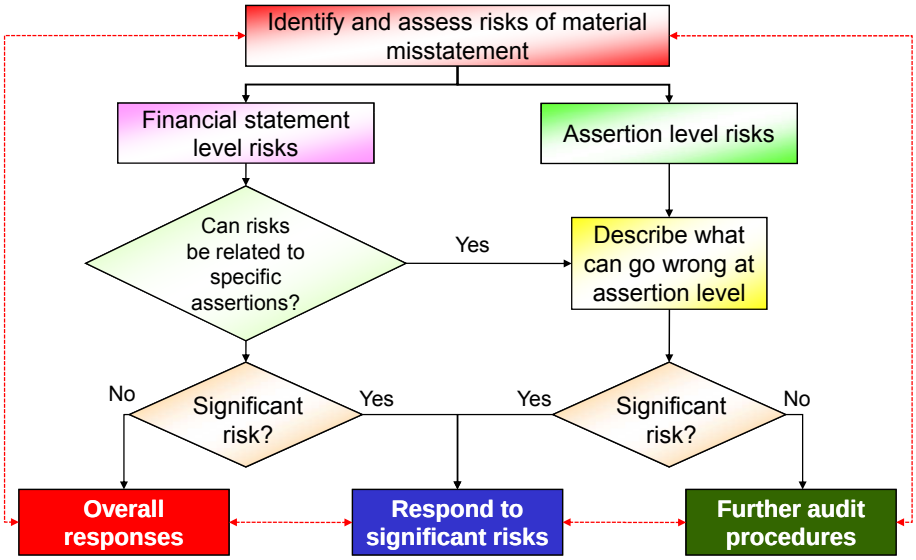
**Example**

During the audit, you find some facts from your client as follows:

- The entity is an owner-managed private entity and thus lacking formal internal control system.
- The computer in recording and preparing the financial information has been upgraded.
- Property acquired in Shanghai during the year
- No property has been acquired before and the owner and staff have no knowledge on accounting new property

Assess the risks and design your response.

# Summary for Reference






# Overall Responses Linked to Risks

**Example**

| Description of the issues identified | Risk resulted | Significant risk (Y/N) | Overall Responses |
|---|---|---|---|
| | | | |
| | | | |
| | | | |

# FAP Linked to Assessed Risks

Example

| Issues and Risks identified | Relevant Assertions | Significant risk (Y/N) | Further Audit Procedures (Audit Responses) |
|---|---|---|---|
| | | | |
| | | | |
| | | | |




# Overall Responses Linked to Risks

Example

| Description of the issues identified | Risk resulted | Significant risk (Y/N) | Overall Responses |
|---|---|---|---|
| 1. The entity is an owner-managed private entity and thus lacking formal internal control system. | The financial statements might have been prepared inaccurately. | Yes | • The audit team is reminded to maintain professional scepticism in performing the engagement.<br>• More experienced audit staff is assigned to the engagement. |
| 2. The computer in recording and preparing the financial information has been upgraded. | The financial information might have not been properly transferred to the new computer. | Yes (Non-routine) | • Audit staff with experience and knowledge in computer data and source information transfer is assigned to the audit team. |
| | | | |

# FAP Linked to Assessed Risks

Example

| Issues and Risks identified | Relevant Assertions | Significant risk (Y/N) | Further Audit Procedures (Audit Responses) |
|---|---|---|---|
| 1. Property acquired in Shanghai during the year | Rights and Obligations | Yes (non-routine) | • Land search performed in Shanghai<br>• Physical inspection and count on property, plant and equipment to be performed |
| 2. No property has been acquired before and the owner and staff have no knowledge on accounting new property | Accuracy, Valuation, Classification | Yes (non-routine) | • Consider the appropriateness of accounting policy on property adopted<br>• Check cost of acquisition to the sale and purchase agreement and match with the payment<br>• Verify the calculation of depreciation independently<br>• Review the entity's impairment review |
| | | | |




# CPA专业方向师资培训 —— Day 6

## End of Afternoon Session

22 August 2007

Full version of the slides can be found in
**www.NelsonCPA.com.hk**

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