A short overview

Dr. Thomas Nösberger
Why do we need audits and auditors?
Importance of Auditing

Information risk reflects the possibility that the information upon which the business risk decision was made was inaccurate.

Auditing can have a significant effect on information risk.
Audit in a nutshell

Reality

Picture (= financial statements)

Balance sheet

| Assets | Liabilities | Equity |

Audit

Risk

Detection

Control

Process

Inherent

Existence
Occurrence
Valuation
Measurement
Completeness
Rights & Obligations
Presentation & Disclosure
The Four Phases Model

Phase 1
Planning and Risk Identification

► Client Acceptance (prospective clients) and Continuance (existing clients).
► Understand the Client’s Business
► Understand the IT Environment Complexity and determine if IT Professional Involvement is necessary.
► Identify Fraud Risks and Determine Responses
► Determine Materiality
Phase 2

Strategy and Risk Assessment

- Identify Significant Classes of Transactions and Related Applications
- Understand Flows of Transactions, WCGWs and Controls → internal control structures, procedures
- Perform Walkthroughs
- Make Combine Risk Assessment (CRA)
Phase 3
Execution: Testing and Evidence

▶ Design Test of Controls and substantive audit procedures
▶ Execute Test of Controls
▶ Execute Substantive Audit Procedures
Phase 4
Conclusion and Reporting

► Assess the conclusions drawn from audit evidence → Prepare Summary of Audit Differences
► Perform final audit procedures (e.g. legal letters, subsequent events, management representations letter).
► Prepare a Management Letter → internal communication
► Prepare the report → external communication
Roadmap

Planning and Risk Identification

- Client Acceptance and Continuance
- Understand clients Business
- Understand IT Environment Complexity and Determine IT Professional Involvement
- Identify Fraud Risks and Determine Responses
- Determine Materiality

Strategy and Risk Assessment

- Identify Significant Classes of Transactions and Related Applications
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- Perform Walkthroughs
- Make Combined Risk Assessments

Execution

- Design Test of Controls
- Execute Test of Controls
- Design substantive audit procedures
- Execute Substantive Audit Procedures

Conclusion and Reporting

- Prepare Summary of Audit Differences
- Perform final audit procedures
- Management Letter
- Report
Risks (Audit Risk Formula)
Component of Audit Risk

**Inherent** risk

- Errors likely to occur in client’s financial statements

**Control** risk

- Errors that bypass controls

**Detection** risk

- Errors not detected by controls

**Audit** risk

- Errors caught by auditor
- Errors undetected by auditor
Different Types of Risk

Inherent Risk
The susceptibility of an account balance, disclosure or class of transactions, considered at the assertion level, to a material misstatement, assuming there are no related controls.

Control Risk
The risk that a material misstatement that could occur in an account balance, disclosure or class of transactions, considered at the assertion level, will not be prevented or detected and corrected on a timely basis by the client’s internal control system.

Detection Risk
The risk that the auditors will not detect a material misstatement that exists in an account balance, disclosure, or class of transactions assertion considered at the assertion level.

Audit Risk
The risk that the auditors may unknowingly fail to modify our opinion appropriately on financial statements that are materially misstated.
Inherent risk

- It implies that auditors should attempt to predict where misstatements are most and least likely in the FS segments (account or class of transactions).
- Inherent risks is a measure of the likelihood that there are material misstatements (errors or fraud) in a segment (class of transactions / account balance) before considering the effectiveness of internal controls.

⇒ At the start of the audit, there is nothing that can be done about changing the inherent risk.
⇒ The auditor must assess the factors that make up the inherent risk and take them into consideration when obtaining audit evidence.
⇒ Auditors begin their assessment of inherent risk during the planning phase and update the assessment as the audit progresses.
**Types of risks: Control Risk**

**Control** risk

The assessment of the likelihood that a misstatement that could occur and that could be material will not be prevented or detected by the internal control system. Ideally, the control system would detect any material errors before they enter the financial statements.
Types of risks: Detection Risk

**Detection risk**
Is a measure of the risk that audit evidence (substantive procedures planned by the auditor to detect material misstatements in the FS: tests of details of transactions, tests of details of balances, and analytical procedures) will fail to detect misstatements that could be material.

- The **Detection risk** depends on other factors and is inversely related to the accumulation of inherent and control risk.

  **Combined Risk Assessment**

- It determines the number of substantial elements of proof the auditor plans to accumulate in order to reduce the **Detection risk** to an acceptable level.
Audit Formula

The audit risk ...

The audit risk is the ultimate acceptable risk that material monetary errors are not detected.

**AUDIT RISK FORMULA**

Inherent Risk × Control Risk × Detection Risk = Audit Risk

Combined Risk Assessment
# Combined Risk Assessment (CRA) Table

<table>
<thead>
<tr>
<th>INHERENT RISK</th>
<th>MINIMUM</th>
<th>MODERATE</th>
<th>MAXIMUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOWER</td>
<td>Minimal</td>
<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>HIGHER</td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
</tr>
</tbody>
</table>

**CONTROL RISK**

- **MINIMUM**: (Effective - Full Tests of Controls)
- **MODERATE**: (Effective - Limited Tests of Controls)
- **MAXIMUM**: (Ineffective - Controls Not Effective, Not Identified or Not Tested)
Relationship between Inherent, Control and Detection Risk

- **Inherent Risk**: Lower → Higher
- **Control Risk**: Min. → Mod. → Max.
- **Combined Risk Assessment**
- **Detection Risk**
- **Audit Risk**

Audit Risk = Combined Risk Assessment × Detection Risk
Relationship between Inherent, Control and Detection Risk

Inherent Risk
- Lower
- Higher

Control Risk
- Min.
- Mod.
- Max.

Combined Risk Assessment

Detection Risk

Audit Risk

Audit Risk = Combined Risk Assessment × Detection Risk
Relationship between Inherent, Control and Detection Risk

Inherent Risk
Lower | Higher

Control Risk
Min. | Mod. | Max.

Combined Risk Assessment
High

Detection Risk

Audit Risk

Audit Risk = Combined Risk Assessment \times Detection Risk
Relation between Risks & Roadmap Relation between Risks & Roadmap

Planning and Risk Identification
- Client Acceptance and Continuance
- Understand clients Business
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Inherent Risk including Fraud Risk

Strategy and Risk Assessment
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Control Risk

Execution
- Design Test of Controls
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Detection Risk

= Audit Risk

Conclusion and Reporting
- Prepare Summary of Audit Differences
- Perform final audit procedures
- Management Letter
- Report
Assertions
The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks.

Assertions:

- Existence / Occurrence
- Completeness
- Valuation / Measurement
- Rights and obligations
- Presentation and disclosure
Definitions

► **Existence** An asset or liability exists at a given date.

► **Occurrence** A recorded transaction or event that pertains to the client actually took place during the period.

► **Completeness** There are no unrecorded assets, liabilities, transactions or events, or undisclosed items.

► **Valuation** An asset or liability is recorded at an appropriate carrying value.

► **Measurement** A transaction or event is recorded at an appropriate amount and in the appropriate account.

► **Rights and obligations** An asset or a liability pertains to the client at a given date.

► **Presentation and disclosure** An item is classified, described and disclosed in accordance with the applicable financial reporting framework.
Assertions

► For example:

► Existence of debtors; Fictitious debtors are booked
► Occurrence of sales; a recorded transaction was effective
► Completeness of liabilities; no liabilities were “off of the books”
► Presentation and disclosure based on IFRS; all disclosures required by IFRS are made
► Valuation and allocation of inventory; inventories have been written down to net realizable value if impaired.
## Assertions connected with the Balance Sheet & Income Statement

### Balance Sheet

<table>
<thead>
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<td>• Existence</td>
<td>• Completeness</td>
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<td>• Presentation and disclosure</td>
<td></td>
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### Income Statement

- Occurrence
- Measurement
- Completeness
- Presentation and disclosure
Materiality
Materiality

Reality

Materiality

Accounting

Materiality

Assets

Equity

Debts

Active

Passive

Accountant

Auditor

Needs Informations for decision

valid Informations
“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 of the error judged in the particular circumstances of its omission or misstatement.

Thus, materiality provides a threshold, or cutoff point, rather than being a qualitative characteristic (which information must have to be useful).”
Materiality

Users

- Unknown to the auditors?
- „The public“ in general
- Specific needs (Banks, Creditors, etc)
- As investor are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users of those financial statements.

Economic Decision

- Decision Model
- Made on the basis of financial statements

This is not applicable in practice  Dilemma
The audit of financial statements aims to enable the auditor to form an opinion as to whether or not the financial statements are prepared, in *all material respects*, in accordance with an applicable financial reporting framework. The assessment of *what is material* is a matter of professional judgment.

Therefore the auditor has to assess what level of error would influence the users of the financial statements (i.e., stakeholders).
Understand the Conditions that Determine Materiality: Planning Materiality (PM)

Materiality is thus the maximum amount by which the auditor believes the financial statements could be misstated and still consideres acceptable given the purpose of the financial statements. It is the degree of inaccuracy or imprecision that is still considered acceptable. The auditor tries to achieve a reasonable degree of certainty whereby the errors in total do not exceed this determined materiality level.

Materiality is used to design the audit, such that the auditor can obtain reasonable assurance that any error, material in size or nature, will be identified. The lower the materiality... the more costly the audit.
Understand the Conditions that Determine Materiality: Tolerable Error (TE)

**Tolerable error** is a concept that enables the auditor to apply planning materiality at the **individual account balance** level. The concept is used to:

- determine which accounts or group of accounts are **significant**
- develop expectations at the desired precision level when performing analytics
- determine the **extent of testing** when using a representative sample or testing various key items
- conclude on the fairness of the presentation

When auditing an individual account balance, it is not appropriate to plan the tests merely to detect errors that would aggregate to the planning materiality. To do so would leave no margin for the audit differences in other accounts or for potential undetected audit differences. Therefore, the tolerable error is established at an amount less than planning materiality.

Tolerable error is set so that the probability is remote that the total of likely misstatements and undetected misstatement in all accounts will **exceed** planning materiality.
Understand the Conditions that Determine Materiality: Nominal Amount (NA)

The nominal amount selected is an amount at which any adjustments below it, individually or in the aggregate, would be immaterial to the financial statements being audited and is an amount consistent with the entity’s expectations. We set the nominal amount at a small percentage (1% to 5%) of Planning Materiality.
Understand the Conditions that Determine Materiality (PM, TE, SAD)

Planning materiality (PM)

Tolerable Error (TE); approx. 50% PM

Nominal Amount approx. 5% PM

Financial Statement

Accounts

Journal Entry
How to resolve the Dilemma?

How to resolve the dilemma?
► Definition is not applicable in practice.
► Professional standards give no additional guidance.
► Concept is never the less critical for the auditor.
► Rules of thumb commonly used in practice:
  ► 5 to 10% of net income before taxes
  ► 5 to 10% of current assets
  ► 5 to 10% of current liabilities
  ► 0.5 to 2% of total assets
  ► 0.5 to 2% of total revenues
  ► 1 to 5% of total equity
Audit Phases

Phase 1: Planning and Risk Identification
Remember the Audit Risk Model

Business of the client, Susceptibility to fraud

Control risk

Detection risk

Audit risk

Errors likely to occur In client’s financial statements

Errors that bypass controls

Errors not detected by controls
Roadmap

Planning and Risk Identification
- Client Acceptance and Continuance
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Strategy and Risk Assessment
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Client Acceptance and Continuance

Accepting the **right client** is the key to avoid audit failure

**Procedures**

- Evaluate the client’s background & reasons for the audit.
- Determine whether the auditor is able to meet the ethical requirements regarding the client.
- Determine need for other professionals.
- Communicate with predecessor auditor.
- Prepare client proposal.
- Select staff to perform the audit.
- Obtain an engagement letter.
Understanding the Business: External Considerations

Understanding of the entity and its environment is an essential aspect of performing an audit. Based on the relevant business conditions, the auditor plans the audit and exercises professional judgment when assessing risks of material misstatement of the financial statements and responds to those risks throughout the audit.

This perspective illustrates how key market forces and other environmental factors may affect the business objectives and strategies.
Understanding the Business: External Considerations

For a business to be successful, its management must satisfy or at least balance its key stakeholders' expectations / requirements, which can sometimes conflict.

To support the understanding of the client’s potential business and/or financial statement risks, the auditor has to consider how client’s key stakeholders (internal or external to the business) influence the actions of management.

Risks can arise, if key stakeholders’ expectations are unrealistic. These may affect management decisions when setting strategies and goals – in response to those unrealistic expectations.

An auditor should also understand the client’s industry because many industries have unique accounting requirements. Understanding the common inherent risks of the relevant industry helps the auditor to identify the inherent risks of an individual company.
Understanding the Business: Internal Considerations

(1) Business operations and processes
- Nature of revenue sources
- Products and services (e.g. pricing)
- Market (e.g. customer group, patents, licenses)
- Key customers and suppliers
- Employment
- Related party transactions

(2) Investment activities
- Acquisitions, disposals of business
- Capital investment
- Investment in non-consolidated entities, partnerships, joint ventures or special purpose entities (SPEs) (Enron created over 3’000 SPEs)
Understanding the Business: Internal Considerations

(3) Capital structure and financing

► Debt structure, leases
► Financing arrangement with subsidiaries, transfer of contracts to SPEs and off-balance sheet financing
► Derivative financial instruments
► Ability to continue as a going-concern

(4) Financial reporting policies

► Accounting principles, presentation and disclosure
► Revenue recognition
► Fair value accounting
► Accounting for unusual and complex transactions
(5) Gain an understanding of the IT environment

► Understand how IT may affect the ability to achieve objectives IT for its internal operations or for a total or partial e-business?

► Understanding of IT infrastructure significant to the audit
  ► operating systems applications databases, interconnectivity

► Understanding the risks arising from the use of IT

► Involvement of an IT specialist?
Understanding the Business: Internal Considerations

Objectives, strategies and related business risks

- Organizational objectives
  - new products, services, expansion of the business

- Understand client objectives in respect of reliability of financial reporting, effectiveness of operations, and compliance with laws

- Potential business risks that may have financial consequences

- Strategies as operational approaches of objectives
Understanding the Business: Internal Considerations

**Measurement and review of performance**

- Internal information may include key performance indicators, budgets, variance analyses, risk reports, and segment information.

- These matters might be considered before performing analytical procedures during the planning phase.

- Internal or external (from analysts and credit rating agency) reports may create pressures on management to misstate the financial statements.

- Examination of such information allows the auditor to assess the risk of material misstatements.
Governance and Internal Control

- Governance includes the client’s organizational structure, the geographical organization, activities of the Board of Directors and the Audit Committee.

- Management’s philosophy and operating style.

- Corporate charter, bylaws, contracts (stocks options, pension plans, leases, bonds payable, etc.)

- Minutes of Meetings

- Code of ethics

- Understanding of internal control

- Many aspects of the nature of the entity can be affected by legal considerations
**Accounting** is the recording, classifying, and summarizing of economic events for the purpose of providing financial information used in decision making.

And the tool is...
Key Risk to IT Environments

► **Reliance on functioning of hardware and software.** Proper physical and logical protection is critical.

► **Visibility of audit trail.** The use of IT often reduces or even eliminate source documents and records that allow the organization to trace accounting information. Other controls must be put in place to replace the traditional ability to compare output information with hard copy. Is there an automated suspense file, and if so, how are suspense items cleared out?

► **Reduced human involvement.** Employees are less able to identify processing misstatements.

► **Systematic versus random errors.** Risk of systematic errors increases.

► **Unauthorized access.** Online access can occur from many remote access points, including by external parties.

► **Loss of data.** Organization may encounter serious business interruptions.

► **Reduced segregation of duties.** Key duties should be appropriately segregated within the IT function.
Identify Fraud Risks and Determine Responses

We maintain an attitude of professional skepticism in all aspects of audit. This includes an ongoing questioning mind and a critical assessment of audit evidence.

We acknowledge that fraud may occur in any entity, at any time, and may be perpetrated by anyone.

We obtain information to identify fraud risk from various sources, including the comprehension we have gained in Understand the Business.

The various sources of information include:

- Making inquiries of management, the audit committee (or those charged with governance), internal audit, and others within the entity
- Considering any unusual or unexpected relationships that have been identified when planning analytical procedures.
- Reviews of interim financial statements
- Considering other information that may be helpful in the identification of fraud risks
- Audit team discussions
Materiality, Planning Materiality (PM)
The extent of misstatement, individually or in aggregate, and in the light of the surrounding circumstances, that probably would have remarkably changed or influenced the judgment of a reasonable person who relies on the financial statements.

Tolerable error (TE)
The application of Planning Materiality at the individual account/balance level. It is defined so that the probability of detected and undetected audit differences in all accounts totally will exceed Planning Materiality is remote.

Nominal amount (NA)
An amount, determined during planning phase, which is applied when posting audit differences to the Summary of Audit Differences. It is the amount below which any reasonably expected accumulation of adjustments would be considered as immaterial and inconsequential to the financial statements being audited.
Roadmap

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Audit Phases

Phase II: Strategy and Risk Assessment
Remember the Audit Risk Model

How many potential errors are caught by existing internal controls

**Control** risk

Errors likely to occur in client’s financial statements

**Detection** risk

Errors that bypass controls

Errors not detected by controls

**Audit** risk
“Internal control is a process, effected by an entity’s Board of Directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations, and Safeguarding of assets against unauthorized acquisition, use or disposition”
Theory of internal control – COSO

Five Components of Internal Control

- Risk assessment
- Control activities
- Information and communication
- Monitoring

Control environment
Integrity and Ethical Values – Sound integrity and ethical values, particularly at top management level, are developed and understood and define the standard of conduct for financial reporting.

Board of Directors – The board of directors understands and exercises oversight responsibility related to financial reporting and related internal control.

Management’s Philosophy and Operating Style – Management’s philosophy and operating style support the achievement of effective internal control over financial reporting.

Organizational Structure – The company’s organizational structure supports effective internal control over financial reporting.

Financial Reporting Competencies – The company retains individuals who are competent in financial reporting and related oversight roles.

Authority and Responsibility – Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.

Human Resources – Human resource policies and practices are designed and implemented to facilitate effective internal control over financial reporting.
Financial Reporting Objectives – Management specifies financial reporting objectives with sufficient clarity and criteria to enable the identification of risks to reliable financial reporting.

Financial Reporting Risks – The company identifies and analyzes risks to the achievement of financial reporting objectives as a basis for determination of how the risks should be managed.

Fraud Risk – The potential for material misstatement due to fraud is explicitly considered when assessing risks to the achievement of financial reporting objectives.
Integration with Risk Assessment – Actions are taken to address risks to the achievement of financial reporting objectives.

Selection and Development of Control Activities – Control activities are selected and developed considering their cost and their potential effectiveness in mitigating risks to the achievement of financial reporting objectives.

Policies and Procedures – Policies related to reliable financial reporting are established and communicated throughout the company, with corresponding procedures resulting in management directives being carried out.

Information Technology – Information technology controls, where applicable, are designed and implemented to support the achievement of financial reporting objectives.
Financial Reporting Information – Pertinent information is identified, captured, used at all levels of the company, and distributed in a form and timeframe that supports the achievement of financial reporting objectives.

Internal Control Information – Information used to implement other control components is identified, captured, and distributed in a form and timeframe that enables personnel to carry out their internal control responsibilities.

Internal Communication – Communication enables and supports understanding and execution of internal control objectives, processes, and individual responsibilities at all levels of the organization.

External Communication – Issues affecting the achievement of financial reporting objectives are communicated with outside parties.
Theory of internal control – COSO
5. Monitoring

► **Ongoing and Separate Evaluations** – Ongoing and/or separate evaluations enable management to determine whether internal control over financial reporting is present and functioning.

► **Reporting Deficiencies** – Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to management and the board appropriately.
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FOT, COT, WCGWs

► Class of Transaction (COT)
  ► Categorises all transaction into different groups

► Significant Class of Transaction (SCOT)
  ► Are classes with high amounts

► Flow of Transaction (FOT)
  ► The way figures come into subledger and general ledger. Enables the auditor to identify where material misstatements could occur.

► What can go Wrong (WCGW)
  ► Refers to points where material misstatements due to error or fraud can occur in a flow of transactions
  ► We focus on those WCGWs that could have a material effect on the related relevant financial statement assertion(s).
Significant Class of Transaction (SCOT) vs. Flow of Transaction (FOT)

**SCOT**

- **Sales 10,000**
  - **Domestic sales 9,900**
    - **Export Sales 100**
      - **NOT SIGNIFICANT**
        - **NO PROCEDURES!!!**
  - **TE: 100**

**FOT**

- **FOT: Domestic Sales**
  - **Customer order**
  - **Production**
  - **Dispatch**
  - **Record & Send Invoice**
  - **Receive Money**

Identify Significant Classes of Transactions and Related Applications
Financial Statement vs. Flow of Transaction

Balance sheet

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Cash

Inventory/PP&E

Flow of Transaction (FOT)

Order

Receive Order Confirmation

GDN (Goods Delivery Note)

Receive & Record Invoice

Pay Invoice

Account Payables

Identify Significant Classes of Transactions and Related Applications
Financial Statement vs. Flow of Transaction

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</table>

Flow of Transaction (FOT)

Customer order → Production → Dispatch → Record & Send Invoice → Receive Money

Identify Significant Classes of Transactions and Related Applications
Understanding FOTs

Critical Path

How the transaction is:
- Initiated
- Authorized
- Recorded
- Processed
- Reported

Segregation of Incompatible Duties

- Custody of assets
- Authorization or approval
- Recording related transactions

IT Considerations

- Automated aspects
- Manual aspects
- Computer applications/infrastructure

Understand Flows of Transactions, WCGWs and Controls
Critical Path

- **Initiated.** The point where the transaction first enters the business flow and is prepared and submitted for recording.

- **Authorized.** General and specific authorization, approval levels and related procedures are designed to ensure that transactions and activities are executed in accordance with management’s intentions. We need to consider the risk that transactions are not executed in accordance with management’s general or specific authorization.

- **Recorded** (information input) The point where the transaction is first recorded in the books and records of the company.

- **Processed** (information is transferred and/or modified) Any changes or transfers of that data in the books and records of the company.

- **Reported** (information is output) The point where the transaction is reported (posted) in the general ledger or subsidiary ledger, which ultimately is reported in the general ledger.
Identify „What Can Go Wrong“

Significant Class of Transactions
From Initiation of Order to Receipt of Goods

Significant Account
Accounts Receivable

Financial Reporting Objectives

- **WCGW** → Existence
- **WCGW** → Valuation
- **WCGW** → Completeness
- **WCGW** → Rights and Obligations

Understand Flows of Transactions, WCGWs and Controls
Categories of Controls

Type of Control

- Manual
- Automated

Objective of Control

- Prevent
- Detect

Misstatement in the Financial Statements

Support the Continued Functioning of Automated Aspects of Prevent and Detect Controls

IT General Controls

Understand Flows of Transactions, WCGWs and Controls
We perform walkthroughs to confirm our understanding of the processes and to verify that the controls we have identified to address WCGWs have been placed in operation. The results of our walkthroughs allow us to evaluate whether or not the controls over the flow of transactions identified are likely to be effective in preventing and detecting material misstatements to the financial statements.

Walkthrough procedures are conducted every year.
Make Combined Risk Assessment

Inherent Risk

Lower  Higher

Control Risk

Min  Mod  Max

Combined Risk Assessment

Detection Risk

Audit Risk

Audit Risk = Combined Risk Assessment

Make Combined Risk Assessments
Roadmap

**Planning and Risk Identification**
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Phase III: Execution
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- Execute Test of Controls
- Design substantive audit procedures
- Execute Substantive Audit Procedures

### Conclusion and Reporting
- Prepare Summary of Audit Differences
- Perform final audit procedures
- Management Letter
- Report
Obtaining and Evaluating Audit Evidence

Based on the assertions, the auditor designs audit procedures to gather sufficient appropriate evidence in order to draw reasonable conclusions based on the audit opinion is given.

Note that in a legal environment there are more rigorous standards of proof and documentation.

Audit Evidence

Evidence is anything that can make a person believe that a fact, proposition or assertion is true or false.

The use of evidence is not unique to auditors. Evidence is a tool which is also common to scientists, lawyers and historians as well.
Not all Audit Evidence is equally reliable. See below for the hierarchy of audit evidence.

<table>
<thead>
<tr>
<th>Source relative to entity</th>
<th>Least reliable</th>
<th>Most reliable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source relative to entity</td>
<td>Internal (from inside entity)</td>
<td>External (from outside entity)</td>
</tr>
<tr>
<td>Source – person:</td>
<td>Employee of company</td>
<td>Employee of company</td>
</tr>
<tr>
<td>Employee or auditor</td>
<td>Employee of company</td>
<td>External auditor</td>
</tr>
<tr>
<td>Source – person:</td>
<td>Employee of company</td>
<td>Employee of company</td>
</tr>
<tr>
<td>Employee of third party</td>
<td>Employee of company</td>
<td>Third party</td>
</tr>
<tr>
<td>Source: Independence of provider</td>
<td>Associated with company</td>
<td>Not associated with company</td>
</tr>
<tr>
<td>Source: Qualification of provider</td>
<td>Little knowledge of subject</td>
<td>Expert in subject</td>
</tr>
<tr>
<td>Source: Operation of internal controls</td>
<td>Not in operation</td>
<td>Effective operations</td>
</tr>
</tbody>
</table>
The Considerations for Determining Whether Audit Evidence is “Sufficient Appropriate Evidence”

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Sufficient and appropriate evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materiality of the item being examined</td>
<td>The more material the item the greater the amount of evidence required</td>
</tr>
<tr>
<td>Effectiveness of management’s responses to risk</td>
<td>More effective management responses to risk and controls decreases quality and quantity of evidence required</td>
</tr>
<tr>
<td>Prior audit experience with the client</td>
<td>Prior audit experience with the client will indicate how much evidence was collected before and if that was enough</td>
</tr>
<tr>
<td>Auditor’s assessment of inherent and control risks</td>
<td>The higher the inherent or control risk, the greater the amount of evidence required</td>
</tr>
<tr>
<td>Reliability of the available information</td>
<td>The less reliable the source of information, the greater the amount of evidence required</td>
</tr>
<tr>
<td>Whether fraud or error is suspected</td>
<td>If fraud is suspected, the amount of evidence required increases</td>
</tr>
</tbody>
</table>
Understand Evidence-Gathering Techniques

Assuming good internal controls and the possibility to choose a method, there are the following techniques to be considered (ordered by their reliability):

1. Recalculation
2. Inspection
3. Reperformance
4. Observation
5. Confirmation
6. Analytical procedures
7. Inquiry
Understand the Seven Evidence Gathering Techniques

1. Recalculation:
   - Consists of examining records, documents, or tangible assets.
     - Example – checking the calculation of depreciation expense.

2. Inspection:
   - Examining records, documents or tangible assets
     - Example – performing an inventory count.

3. Re-performance:
   - Independent execution of procedures or controls that were originally performed as part of the entity’s internal control.
     - Re-perform the aging of accounts receivable.
Understand the Seven Evidence Gathering Techniques

4. Observation:
   ► Observe a process or procedure being performed by another.
     ► Performing a site visit at the client’s facilities.

5. Confirmation:
   ► The auditor’s receipt of a written or oral confirmation from a
     independent third party verifying the accuracy or the information
     requested.
     ► Four Key Characteristics:
       1. Information is requested by auditor.
       2. Request and response is in writing, sent to the auditor.
       3. Response comes from an independent third party.
       4. Positive confirmation involves a receipt of information.
Understand the Seven Evidence Gathering Techniques

6. Analytical Procedures:
► Analysis of significant trends and ratios including the investigation of fluctuations and relationships that are inconsistent with other relevant information or that deviate from predictable amounts.
  ► Example: Examining sales on a monthly basis to look for unusual spikes or strange seasonality.
  ► All unusual trends must be explained by the client. A lack of or unusual explanations, indicates that additional testing should be performed.

7. Inquiry:
► Seeking information from knowledgeable persons inside or outside the entity.
  ► Obtaining an email confirmation relating to intercompany cash balances.
Determine PM, TE and SAD Nominal Amount

Design Tests of Controls

Make Combined Risk Assessments

Perform Walkthroughs

Understand Flows of Transactions, WCGWs and Controls

Identify Significant Classes of Transactions and Related Applications

Identify Fraud Risks and Determine Responses

Understand Business

Understand IT Environment Complexity and Determine IT Professional Involvement

Client Acceptance and Continuance

Determine Materiality

Roadmap

Planning and Risk Identification

Strategy and Risk Assessment

Execution

Conclusion and Reporting

Design Test of Controls

Execute Test of Controls

Design substantive audit procedures

Execute Substantive Audit Procedures

Prepare Summary of Audit Differences

Perform final audit procedures

Management Letter

Report
The Process of Auditing Based on Internal Controls

1. Obtain understanding
   - Obtain an understanding of the control structure
   - Document the understanding

2. Initial assessment and response to control risk
   - Initial assessment of control risk
   - Set level of control risk
   - Response to control risk
   - Prepare planning memo and audit plan (program)

3. Final assessment based on control tests of operation
   - Perform tests of control
   - Evaluate sufficiency of evidence and reassess internal control risk

Continue
   - Reduce or No change
   - Reduce or increase risk?
   - Increase

Audit Plan
   - Control environment
   - Information system
   - Transactions and records
   - Checklist
   - Questionnaire
   - Flowchart
   - Narrative
   - Identify relevant controls
   - Evaluate weakness
   - Audit procedures:
     - Nature
     - Timing
     - Extent
   - Nature:
     - Inquiry
     - Observation
     - Inspection
     - Reperformance
     - Timing
     - Extent

Revise Audit Plan
Designing Test of Controls

Remember, in the walkthrough phase, we determine the WCGW’s and the related internal controls.

Now, we determine which controls need to be tested. These controls are named “key” controls.

“If a key control is fails, then there is at least a reasonable likelihood that a material error in the financial statements would not be prevented or detected on a timely basis.”

These “key” controls must be tested in order to be able to rely on the process and the internal control.
Designing the Test of Controls

Once “key” controls have been determined, we must decide:

► How the control is to be tested.
  ► What characteristic are we looking for (e.g.: sign-off, three way match, etc)?

► How to determine the sample size.
  ► Daily transactions = test of 25
  ► Quarterly transactions = test of 2
  ► Monthly transactions = test of 2
  ► Annual transactions = test of 1

► How the selections are to be made.
  ► Judgmentally or using a random number generator, etc.
Execute and Evaluate - Test of Controls

Executing the Test of Control - to obtain evidence that those controls that are relied upon are properly designed and operating effectively throughout the period of reliance.

No errors in the testing allow the auditor to say that the process is working effectively.

One error in the testing could mean that the process is ineffective. We could say that control is ineffective, and control risk = high.

We could decide to test an additional sample (of 15). If no errors are found, we can conclude that the process is effective.

Many errors = process ineffective, control risk = high.
Design Substantive Procedures

The auditor designs audit procedures to gather sufficient appropriate evidence in order to get **reasonable assurance** that the balances are correct.

The Auditor’s Substantive procedures are designed while taking the following points into account:

1) **The Control Risk Assessment** – Determined after the TOC is completed.  
   **Example**: If the TOC of inventory fails, the amount of required substantive procedures related to inventory increases.

2) **The Account Assertions** – The significant account assertions determined in the planning stage must be addressed.  
   **Example**: If existence and valuation are the assertions related to inventory, we need to perform adequate substantive worksteps to assess those assertions.
Design Substantive Procedures – Explain Nature and Extent

**Nature**

The nature of a planned audit procedure refers to both the *type* of procedure and *method* used to gather the evidence. As some types and methods are considered to gather evidence of greater *reliability* than others.

*(Refer back to the audit evidence techniques for the level of reliability for each different type of evidence)*

- According to auditing rules, adequate procedures must be performed for each account that is considered to be significant, at a minimum.

  ➔ We call these [primary substantive procedures](#) *(These procedures include items such as confirmations for cash or receivables, cut-off testing for receivables and payables, revenue recognition procedures, etc.)*
Design Substantive Procedures – Explain Nature and Extent

**Extent**
The higher the risk of material misstatement, the greater the extent of testing. In planning substantive testing, the extent determines the sample size, which is affected by the risk of material misstatement.

**Audit Sampling** is the determination of which, and how many, items will be selected for testing.

**Statistical sampling** allows the auditor to achieve high confidence levels without having to perform audit procedures on the entire population. Sampling can be designed to reach confidence levels of 90%, 95%, 97% or whatever is deemed reasonable. In order for the statistical sampling to be effective, selection must be made in an unbiased manner, where all sampling units have a chance of being selected.

**Risk of Sampling**
The risk of sampling arises from the possibility that the auditor’s conclusion, based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure.
Different types of sampling.

Audit sampling can use either a statistical or a non-statistical approach

- **Statistical sample selection** is a method of selecting a sample so that each population item has a known probability of being included in the sample.

- **Non-Statistical sample selection** is a method, where professional judgment is used rather than probabilistic methods.

**Professional Judgement**

Auditors use the knowledge, skills, and experience given by their profession to diligently perform the gathering of evidence in good faith and with integrity.

The exercise of professional judgment allows auditors to obtain reasonable assurance that material misstatements or significant inaccuracies in data will likely be detected if there are any. Absolute assurance is not attainable because of the nature of evidence and the characteristics of fraud.

However, if the auditor is involved in a lawsuit, it can be difficult to justify the use of professional judgment. For this reason, statistical sampling is becoming more used in the audit field.
Perform Substantive Audit Procedures

Determine testing scope

- Assertion
  - Assets
    - CRA
      - 75 – 100% of TE
      - 50 - 75% of TE
      - 25 - 50% of TE
      - 10 - 25% of TE
      - Professional Judgment
  - Liabilites

Perform substantive audit procedures

Conclusion

- Audit Diff.
  - Diff. > SAD
    - End
    - SAD
    - End
Audit Phases

Phase IV
Remember the Audit Risk Model

**Control** risk

**Detection** risk

**Audit** risk

Errors likely to occur in client’s financial statements

Errors that bypass controls

Errors not detected by controls

Risk that the results of the audit are not correct.
Summary of Audit Differences (SAD)

➢ The SAD is a document that summarizes both recorded and unrecorded audit differences identified during the audit.

➢ The SAD also contains a conclusion statement including an evaluation of the materiality of the aggregate effect of the unrecorded audit differences on the financial statements.
Perform Final Audit Procedures

► Final financial statement review

► Prepare the Management Representation letter
  ► Auditors request management to confirm that they are responsible for the preparation and presentation of the financial statements, that they have provided the auditor with all relevant information and that all transactions have been recorded and are reflected in the financial statements.

► Prepare a Legal letter
  ► Auditors request the legal representative(s) to confirm that the client has no outstanding legal matters.

► Subsequent Events
  ► Events occurring between balance date and the date of the audit report are referred to as subsequent events.
Management Letter

The auditor may provide a management letter that discusses internal control and other matters identified during the course of the audit, ‘early warnings’ on emerging issues, and business insights. The auditor typically discusses in his management letter the circumstances that led to any significant adjustments and consider whether they represent a significant deficiency. The auditor does this even if the aggregate net differences are not material.

When the auditor has identified risks that implicate fraud, or whenever we believe that there is evidence of fraud or fraud may exist, the auditor considers communicating these matters to management.

A management letter is a deliverable prepared by the audit team and provided to the client at the end of the audit. (Internal Report)
Report

Reality

Needs Informations for decision

valid Informations

Communicates with the audit report

Accountant

Auditor

Active

Passive

Assets

Equity

Debts

Reality

Report

Communicates

with the audit report

Needs Informations for decision

valid Informations

Accountant

Auditor
The audit report is the only output visible to the public from the auditor.

A standard audit report comprises of 420 words in Switzerland.

Novartis paid for the 2008 audit 29.1 mio. ➔ 70 T USD per word

Ci Com – a listed inactive company in Switzerland – paid for the 2007 audit 125 TCHF ➔ 300 CHF per word
Four Types of Audit Reports

- **Standard Unqualified**
- **Qualified Opinion**
- **Unqualified Adding an Emphasis of Matter Paragraph**
- **Disclaimer or Adverse Opinion**
Unqualified opinion

► Acceptable accounting policies, consistently applied.

► Compliance of financial information with relevant requirements.

► Consistency of the presentation as a whole with auditor’s knowledge of the business.

► All material matters are adequately disclosed.
Matters that **Do Affect** the Auditor’s Opinion

1. **Scope Limitation**
   - Qualified Opinion
   - Disclaimer of Opinion

2. **Disagreement with Management regarding:**
   - acceptability of accounting policies
   - method of application and adequacy of disclosures
   - compliance of statements with relevant requirements
   - Qualified Opinion
   - Adverse Opinion
Matters that **Do Affect**
the Auditor’s Opinion

**Qualified Opinion**

- Can result from scope limitation or failure to follow GAAP.
- The qualified opinion has a third paragraph before the opinion paragraph.
- Qualified opinion expressed as fairly presenting the statements “except for the effects” of the matter to which the qualification relates.
Matters that **Do Affect** the Auditor’s Opinion

**Adverse Opinion**

The auditor believes that the overall financial statements are so **materially misstated** or misleading that they do **not** present the financial condition of the company in a fairly manner.

The disagreement is discussed in a third paragraph before the opinion paragraph.

Such reports are issued only after all attempts to persuade the client to adjust the statements.

The only available option is withdrawal from the engagement.
Matters that Do Affect the Auditor’s Opinion

Disclaimer of Opinion

The auditor has not been able to obtain sufficient and appropriate audit evidence.

The paragraph discussing the scope would either be omitted or amended.

Add a paragraph or sentence discussing the scope limitation.

Because of the significance of the matters discussed, the auditor is not able to express an opinion on the statements.
Matters that Do **Not Affect** the Auditor’s Opinion

- Adding an emphasis of matter paragraph to highlight a matter affecting the financial statements.
- Such an emphasis of matter paragraph does **not** affect the auditor’s opinion.
- The paragraph should follow the opinion paragraph and state that the auditor’s opinion is not qualified.

**Matters affecting the financial statements**

**Report on matters other than those affecting the financial statements**
Matters that Do **Not Affect** the Auditor’s Opinion

**Matters affecting the financial statements**

**Significant uncertainty** - the resolution of which is dependent upon future events or events not under the direct control of the entity which is included in the notes.

**But:** If uncertainty is significant and not adequately disclosed in the notes the auditor may choose to issue a qualified opinion or disclaimer of opinion.

In extreme cases, such as situations involving multiple significant uncertainties, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.
Matters that Do Not Affect the Auditor’s Opinion

Matters affecting the financial statements

Doubts about the appropriateness of the going concern assumption in the foreseeable future.

The auditor in a paragraph:

► Describe the conditions that raise doubt.
► State the entity may be unable to realize its assets and discharge its liabilities in the normal course of business.
► State that the financial statements do not include any adjustments relating to the matter.

But: If adequate disclosure is not made in the notes, the auditor should express a qualified or adverse opinion as appropriate.
Matters that Do Not Affect the Auditor’s Opinion

Matters other than those affecting the financial statements

Subsequent events (NAS 560), occurring between the balance sheet date and the date when the financial statements are authorized for issue, which are indicative of conditions that arose after the balance sheet date.
# Relationship of Materiality to Type of Opinion

<table>
<thead>
<tr>
<th>Materiality Level</th>
<th>Significance in Terms of Reasonable Users’ Decisions</th>
<th>Type of Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immaterial</td>
<td>Users’ decisions are unlikely to be affected.</td>
<td>Unqualified</td>
</tr>
<tr>
<td>Material</td>
<td>Users’ decisions are likely to be affected.</td>
<td>Qualified</td>
</tr>
<tr>
<td>Highly material</td>
<td>Users’ decisions are likely to be significantly affected.</td>
<td>Disclaimer or adverse</td>
</tr>
</tbody>
</table>
END