

# **Auditing in a Changing Environment**

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# **Audit Planning, Execution & Audit Evidence**

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# Changing Environment

- New accounting standards
- Technology – data processing, communication and operations
- Globalization
- New laws and regulations:
  - Greater responsibility of directors and managers
  - More detained reporting on their stewardship
- Concerns emanating from current/recent financial crisis

Douglas Carmichael, the chief auditor and director of professional standards of her Public Company Accounting Oversight Board, said:

“My hope is that auditors will respond to their new role .....result will be a renewed spirit of professionalism and a dedication to the auditor’s role of protecting investors and furthering the public interest in the preparation of informative, fair and accurate independent audits.”

# Overview

- Audit work should be planned so that the audit will be performed in an ***effective manner***.
- The Planning entails the development of:
  - A general strategy (the overall audit plan); and
  - A detailed approach for the ***nature, timing*** and ***extent*** of the audit procedures (the audit programme)

# Objectives

- The objectives of the plan are to ensure that the auditor:
  - devote appropriate attention to important areas
  - identify potential problems
  - complete work expeditiously
  - assign and co-ordinate audit work appropriately

# Planning

The work is to be adequately planned, and assistants, if any, are to be properly supervised.

Acceptable audit risk – how willing is auditor to accept that the financial statements may be materially misstated after the audit is completed & the opinion is issued.

# Risk of Material Misstatement

Inherent risk – assessment of likelihood that there are Material misstatements in accounts before considering effectiveness of internal controls.

Control risk – assessment of likelihood that misstatements exceeding a tolerable amount in accounts will not be prevented or detected by the client's internal controls.



# The Audit Risk Model

DR = (Detection risk)

AR = (Audit risk)

(IR x CR) = (Inherent risk x Control risk)

# The Audit Risk Model

- Audit risk can be expressed in the following model which assumes the elements to be independent:
- Audit risk (AR) = Inherent risk (IR) x Control risk (CR) x Detection risk (DR).
- $AR = IR \times CR \times DR$

# Preliminary Assessment of Planning Materiality

- Materiality is considered to be the largest amount of uncorrected dollar misstatement that could exist in published financial statements, yet still be fairly presented in conformity with IAS (i.e. not misleading).

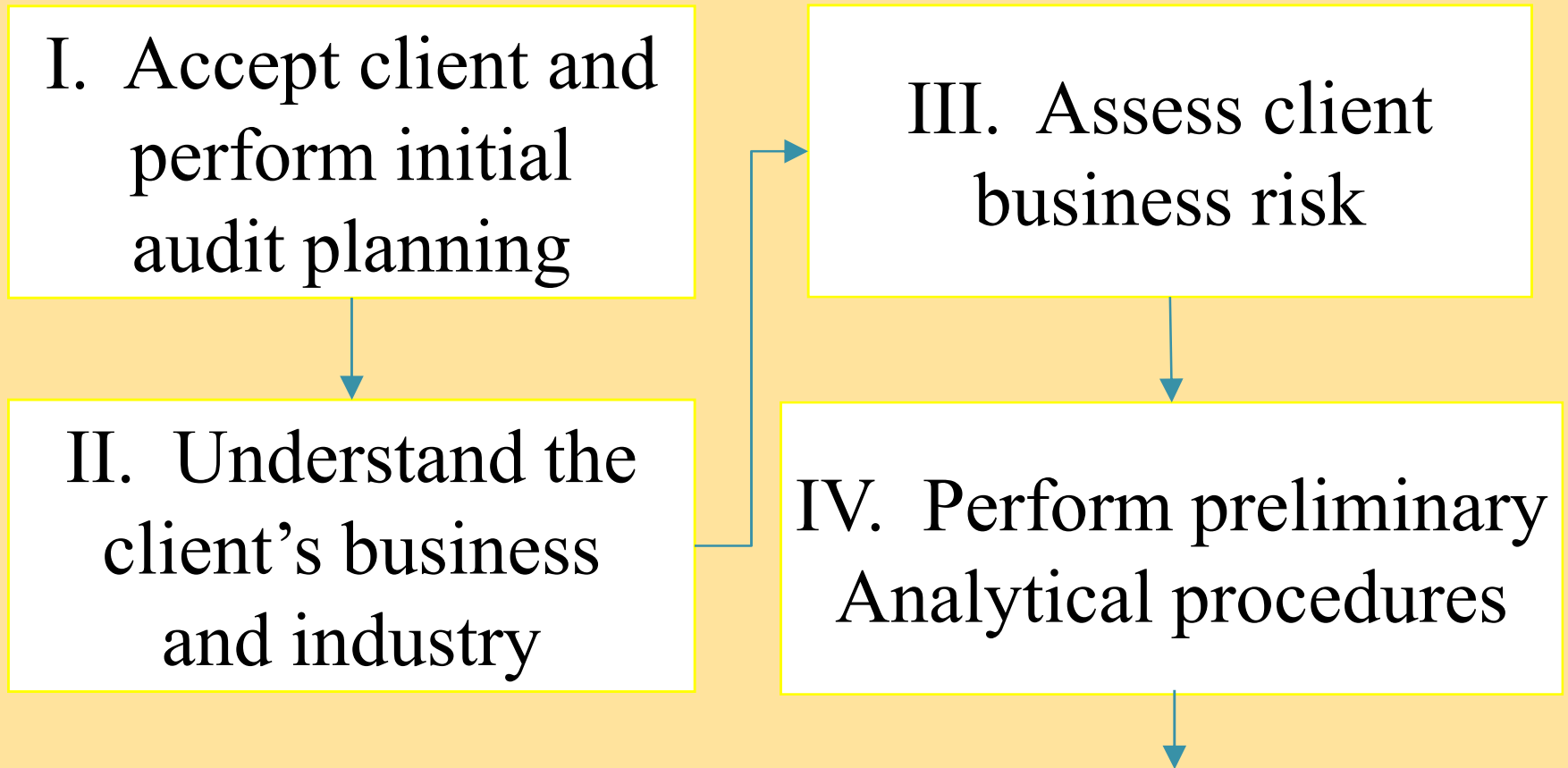
# Planning Materiality

- **Some of the common factors auditors use in making judgment are:**
  - absolute size,
  - relative size,
  - nature of the item or issue,
  - circumstances,
  - uncertainty, and
  - cumulative effects.

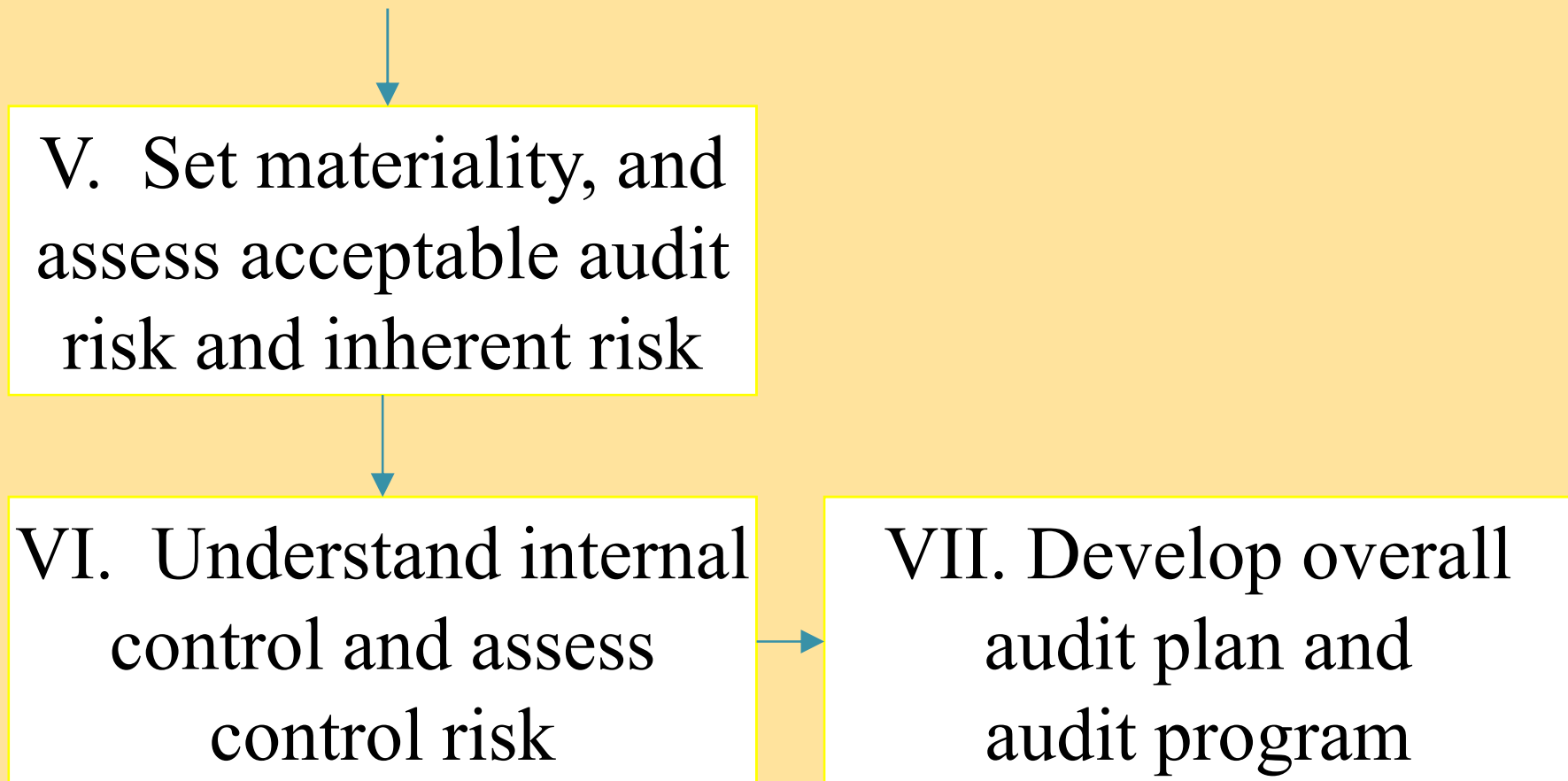
# Planning Materiality

- **The concept of materiality is used by auditors as a guide**
  - to planning the audit program,
  - to evaluation of the evidence, and
  - for making decisions about the audit report.

# Planning an Audit and Designing an Approach



# Planning an Audit and Designing an Approach





# Initial Audit Planning

Should the auditor accept a new client?

- Identify why the client wants or needs an audit.
- Obtain an understanding with the client.
- Select staff for the engagement.



# Terms of Engagement

- Agreed terms need to be recorded in an audit engagement letter or other form of contract.
- Purpose:
  - To help to avoid misunderstandings between client and auditor.
  - To confirm:
    - Auditor's acceptance of appointment
    - Objective and scope of audit
    - Extent of auditor's responsibilities to the client
    - Form of any reports



# Understanding of the Client's Business and Industry

Understand Client's Business and Industry

Industry and External Environment

Business Operations and Processes

Management and Governance

Objectives and Strategies

Measurement and Performance



# Understanding of the Client's Business and Industry

What are some factors that have increased the importance of understanding the client's business and industry?

Information  
technology

Global  
operations

Human  
capital



# Industry and External Environment

What are some reasons for obtaining an understanding of the client's industry and external environment?

Risks associated  
with  
specific industries

Inherent risks  
common to all  
clients in certain  
industries

Unique accounting  
requirements

# ✚ Business Operations and Processes

Factors the auditor should understand:

- major sources of revenue
- sources of revenue
- key customers and suppliers
- sources of financing
- information about related parties
- ability to obtain financing



# Management & Governance

- Management establishes the strategies and processes followed by the client's business.
- Governance includes the client's organizational structure, as well as the activities of the board of directors and the audit committee.
- Corporate charter and bylaws
- Minutes of meetings



# Client Objectives & Strategies

Strategies are approaches followed by the entity to achieve organizational objectives.

Auditors should understand client objectives.

Financial  
reporting  
reliability

Effectiveness  
and efficiency  
of operations

Compliance  
with laws and  
regulations

## F. Measurement and Performance



The client's performance measurement system includes key performance indicators. Examples:

– market share	– sales per employee
– unit sales growth	– Web site visitors
– same-store sales	– sales/square foot

Performance measurement includes ratio analysis and benchmarking against key competitors.



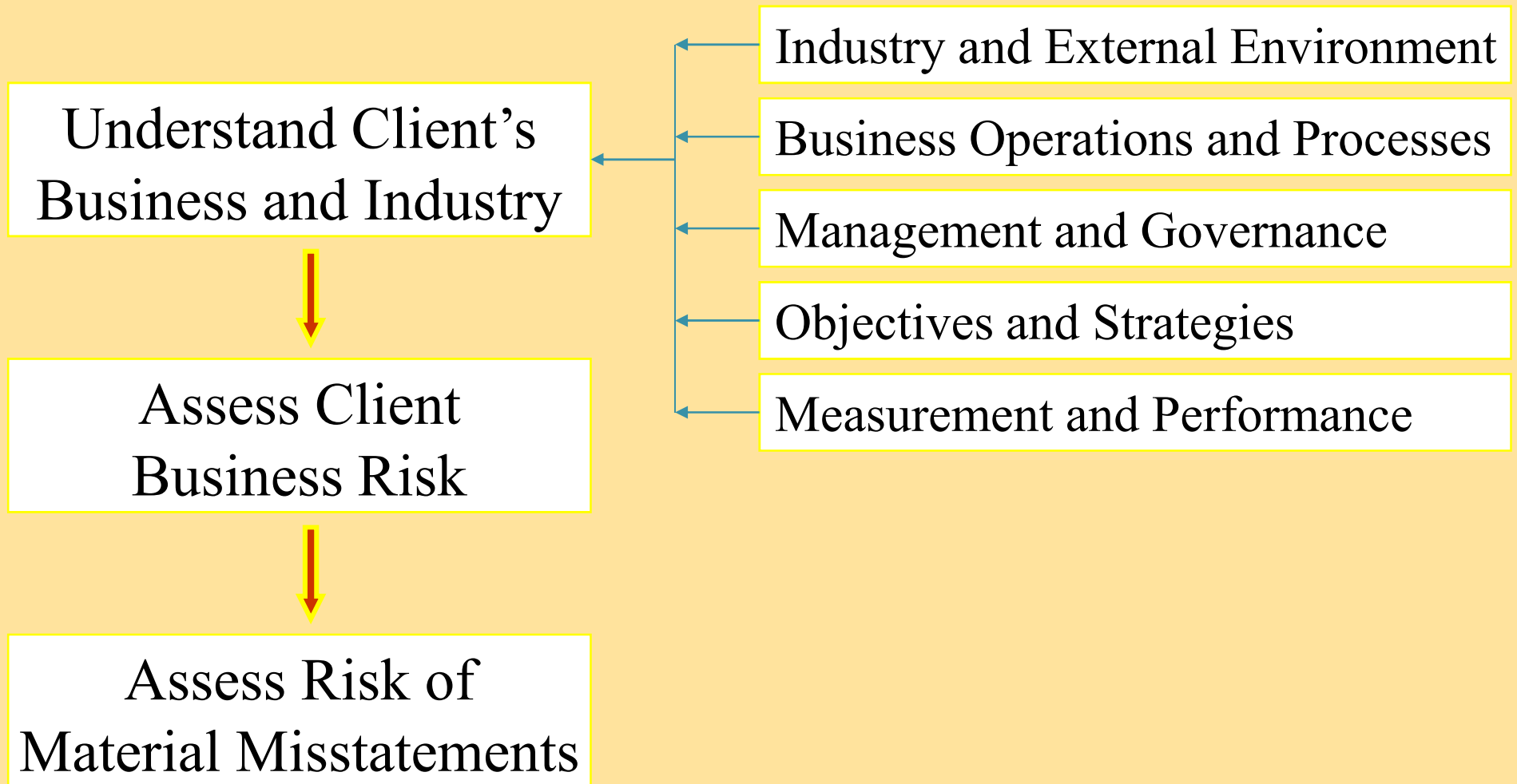
# Assess Client Business Risk

- Client business risk is the risk that the client will fail to achieve its objectives.

What is the auditor's primary concern?

material misstatement of the financial statements due to client business risk

# The Client's Business Risk, and Auditor's Risk Assessment



# Perform Analytical Procedures

**First**, analytical procedures use comparison of client ratios to industry or competitor benchmarks to provide an indication of the company's performance.

**Second**, analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

# Timing and Purpose of Analytical Procedures

Purpose	<b>(Required)</b> Planning Phase
Understand client's industry and business	Primary purpose
Assess going concern	Secondary purpose
Indicate possible misstatements (attention directing)	Primary purpose
Reduce detailed tests	Secondary purpose

# Timing and Purpose of Analytical Procedures

Purpose	Testing Phase
Understand client's industry and business	Secondary purpose
Assess going concern	
Indicate possible misstatements (attention directing)	
Reduce detailed tests	
	Primary purpose

# Timing and Purpose of Analytical Procedures

Purpose	(Required) Completion Phase
Understand client's industry and business	
Assess going concern	Secondary purpose
Indicate possible misstatements (attention directing)	Primary purpose
Reduce detailed tests	

# Five Major Types of Analytical Procedures

1. Compare client and industry data.
2. Compare client data with similar prior-period data.
3. Compare client data with client-determined expected results.
4. Compare client data with auditor-determined expected results.
5. Compare client data with expected results, using nonfinancial data.

# Common Financial Ratios

Short-term debt-paying ability

Liquidity & activity ratios

Ability to meet long-term debt obligations

Profitability ratios



# Short-term Debt-paying Ability

Cash ratio:

$(\text{Cash} + \text{Marketable securities}) \div \text{Current liabilities}$

Quick ratio:

$(\text{Cash} + \text{Marketable securities} + \text{Net accounts receivable}) \div \text{Current liabilities}$

Current ratio:

$\text{Current assets} \div \text{Current liabilities}$

# Liquidity Activity Ratios

Accounts receivable turnover:  
 $\text{Net sales} \div \text{Average gross receivables}$

Days to collect receivables:  
 $365 \text{ days} \div \text{Accounts receivable turnover}$

Inventory turnover:  
 $\text{Cost of goods sold} \div \text{Average inventory}$

# Liquidity Activity Ratios

Days to sell inventory:  
 $365 \text{ days} \div \text{inventory turnover}$



# Ability to Meet Long-term Debt Obligation

Debt to equity:  
 $\text{Total liabilities} \div \text{Total equity}$

Times interest earned:  
 $\text{Operating income} \div \text{Interest expense}$

# Profitability Ratios

Return on equity:

$\text{Net Income} \div \text{Average (or Total) equity}$

Return on assets:

$\text{Net income} \div \text{Average total assets}$

Profit Margin:

$\text{Net income} \div \text{Net Sales}$

# Summary of Analytical Procedures

They involve the computation of ratios and other comparisons of recorded amounts to auditor expectations.

They are used in planning to understand the client's business and industry.

They are used throughout the audit to identify possible misstatements, reduce detailed tests, and to assess going-concern issues.

# Audit Programs

- An internal control program contains procedures to obtain an understanding of the client's business and management's control structure, and for assessing the inherent and control risk.
- A balance-audit program contains substantive procedures for gathering direct evidence about the seven assertions about dollar amounts in the account balances

# Accounting Assertions

- In case anyone asks they are as follows:
  - Existence
  - Completeness
  - Occurrence
  - Valuation (Measurement)
  - Rights and obligations
  - Presentation and disclosure
  - Appropriate carrying value



# Summary of the Purposes of Audit Planning

Gain an understanding of the client's business and industry.

Assess risks – business risk, inherent risk, control risk, and acceptable audit risk.

Set materiality and develop overall audit plan and audit program.

# Audit Approach

- Test of control **systems**:
  - Strong controls
  - Reliance on internal controls supported by
  - satisfactory results of tests of control
    - Control is tested not the transaction.
- **Substantive** procedures:
  - Tests of details of transactions and balances
  - Analytical procedures

# Audit Evidence

- ISA 500 demands that audit evidence should meet the following criteria:
  - **Sufficient** (Difficulty and expense are not valid reasons for omission)
  - **Appropriate**
    - Relevant
    - Reliable

# Audit Evidence

- Audit evidence is the information obtained by the auditor from which reasonable conclusions can be drawn, as a basis for the audit opinion

# Gathering Audit Evidence

- **Selection Methods:**
- Any one or a combination of:
  - Selecting all items
  - Selecting specific items
  - Audit sampling
- Risk considerations
  - Inherent , control and detection risk
  - Sampling and non-sampling risk

# Selecting All Items

- Population consists of a small number of large value items
- Items to which nonmonetary materiality does not apply
- Unusual one-off or exceptional items
- Any area where the auditor is put on enquiry
- Exceptionally risky areas
- When the repetitive nature of a CIS operation makes 100% examination cost effective.

# Audit Sampling

- **Judgmental selection:**
  - Knowledge of business
  - Preliminary assessment of inherent and control risk
  - Characteristics of the population
- **Advantage:**
  - Usually efficient means of gathering evidence
- **Disadvantage:**
  - Not statistical. Cannot project results to population

# Audit Sampling

Items should be selected in such a way that all sampling units have a chance of selection.

For statistical sampling the sampling items must be randomly selected.

*computer generated random numbers or random number tables must be used.*

Systemic selection – set interval with random start.



# The Audit Plan

- At this stage you should have:
  - Assessed the audit risk;
  - Devised a programme to efficiently minimize the audit risk;
  - Documented the clients systems and your assessment of them;
  - documented/tailored the audit programme;
  - Prepare junior staff for the assignment.

# Thank You

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