

Applying auditing standards

Stuart Hartley advises on how to run a cost-effective audit

A full understanding of the International Standards on Auditing requirements can help improve a firm's quality control, and identify workflow changes needed and areas where staff training is required.

It is important for auditors to review whether the risk-based approach, which became effective for audits in 2005 and underpins the standards, is being applied cost-effectively. Firms should review if they need to fine-tune their approach in preparation for more changes to the standards.

The International Auditing and Assurance Standards Board in August 2009 issued a question and answer document, "Applying ISAs Proportionately with the Size and Complexity of an Entity." Not knowing the standards well can create uncertainty, resulting in time wasted deliberating over requirements and unnecessary work. In some cases, the entire risk assessment phase of the audit could become simply an "add-on" to the other substantive audit work.

Professional judgment is needed to scale the work according to the size and complexity of the entity being audited and the risks involved. Here are some points to consider when applying the ISAs:

Identify sources of risk, not just the effects

When auditors are asked to identify risks, they tend to start by reading the financial statements. While this may identify the effect of risks, the sources of such risks

may remain undetected, for example, risks from adverse industry trends or from an accountant prone to error.

If the sources of risk are first identified, then they can be linked to possible effects in the financial statements. For example, a source of risk could be declining demand for the entity's products, which could lead to a misstatement in the valuation of inventory.

But it would be a mistake to stop there as other misstatements emanating from this source of risk could be possible.

Declining sales might also mean a sales manager just missed a bonus threshold, banking covenants could be breached, or a going concern issue may exist. In fact, what seems on the surface to be a

straightforward business risk may give someone the opportunity or incentive to commit fraud - take for example that sales manager who stands to get a smaller bonus.

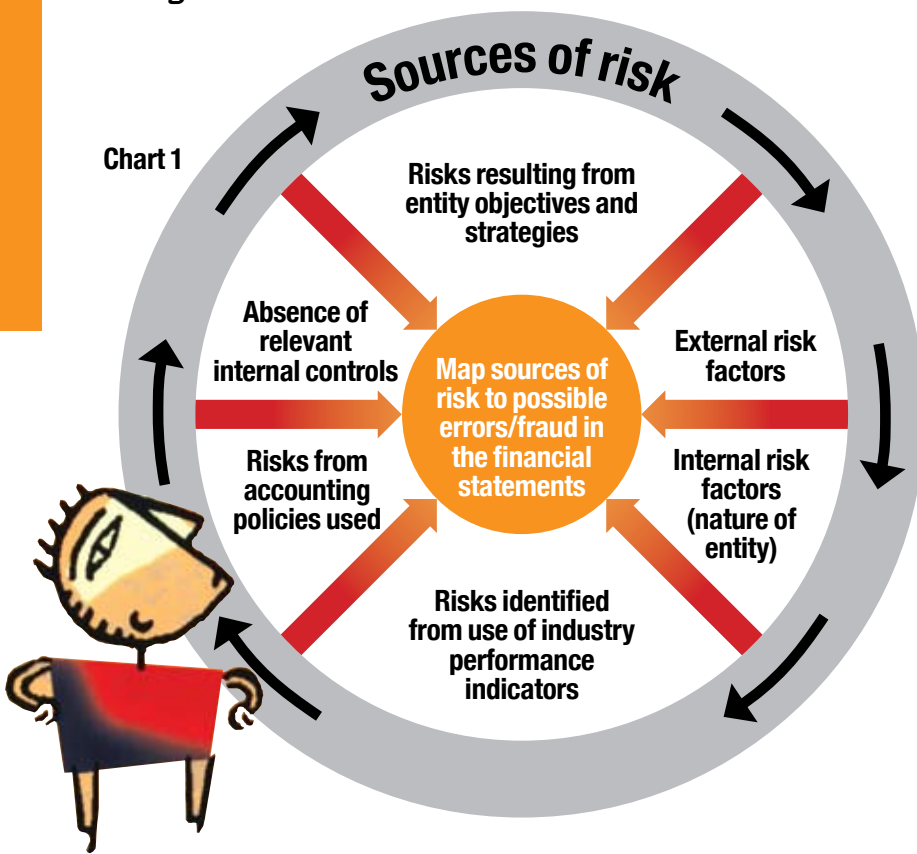
Therefore, risk identification should come from an understanding of the entity as a whole, not just from reading the financial statements (*see chart 1*).

When obtaining information about each area, take time to identify possible sources of risk. Then consider what misstatements could occur in the financial statements as a result, especially those that might arise due to fraud.

Many of the risk sources identified in this way are likely to be pervasive (they cannot be allocated to specific assertions), which



Chart 1



Ensure each staff member understands the necessity and purpose of the documentation with which they are working. Countless hours can be wasted when employees attempt to complete a form they do not understand.

Because fraud is deliberate, detecting it may require some element of unpredictability, such as performing certain surprise audit procedures. Encourage staff to be sceptical and inquisitive, and raise issues, observations or unexplained matters. Fraud may be discovered by piecing together a number of small matters that, if considered separately, might seem insignificant.

Understand the control environment

Clearly define all control measures when obtaining an understanding of internal control relevant to the audit. Pervasive controls and transactional controls are different: The former address integrity and ethics, corporate governance, employee competence, management attitudes toward control, fraud prevention, risk management, and control monitoring.

Chart 3 illustrates one way of viewing

will help in assessing risks at the financial statement level. The identification of pervasive risks might also yield information useful for constructive recommendations in other areas for the entity.

Plan well before starting an audit

For every hour spent planning, five hours can be saved in execution. Many small and medium practices find effective audit planning makes the difference between a quality audit within budget and a poor quality audit over budget.

The undistracted time of the engagement partner and staff, and the willingness to make important decisions based on appropriate professional judgment are the ingredients for effective planning. But dedicated team meetings held in the office are not always necessary. Planning for small engagements can be done through brief discussions at the start of the engagement and as the audit progresses.

When you plan, the team needs to know all about the entity, including changes in the past year and the likely implications of those changes.

At this stage, it is necessary to address audit inefficiencies identified in prior year engagements and ensure the staff fully

understands what they need to do. Key questions that should be discussed at the planning session are included in chart 2.

Encourage staff to identify areas where audit procedures seem excessive in relation to the risk of misstatement. For example, if a number of account balances are immaterial, is it necessary to perform a long list of standard audit procedures that might be more applicable to a much larger balance?

Chart 2



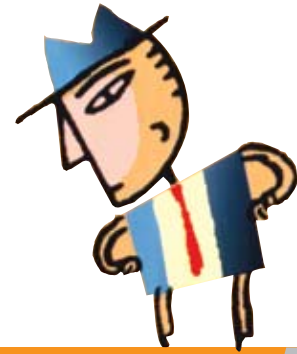
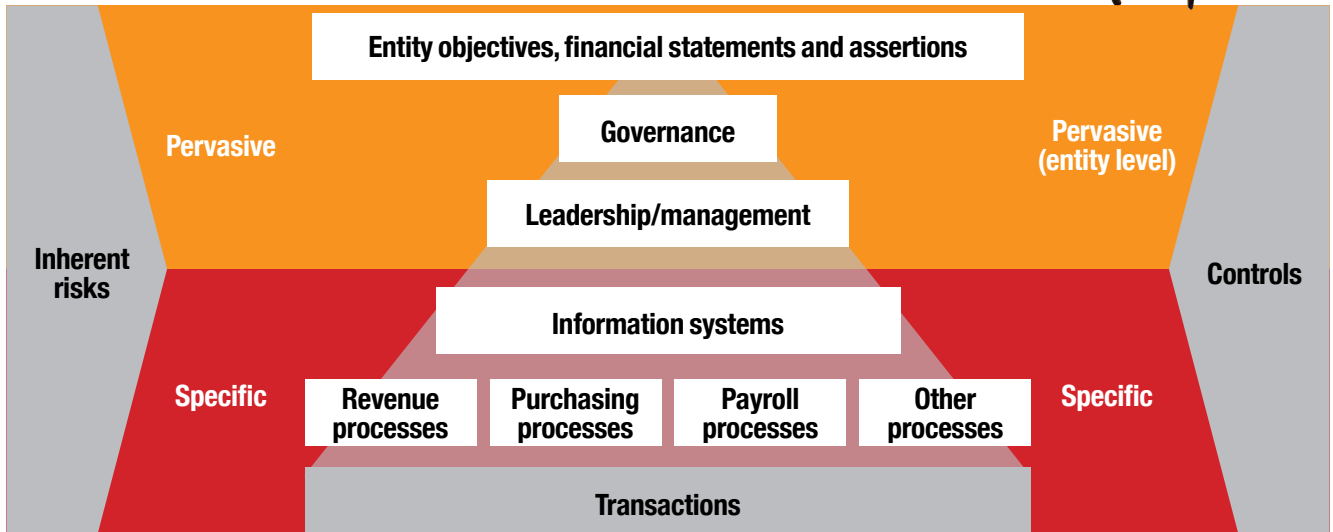


Chart 3



pervasive and transactional controls.

The most important controls in entities of any size are those found in the control environment, which states the values of the entity and management's commitment to competency and ethics.

When this is applied well, the owner-manager of a small entity can exercise effective control over transactions that would require extensive segregation of duties in a larger entity. However, if the entity's values are weak, management overrides can easily occur and even the very best transactional controls over such processes as purchases and sales could fail.

Aim for continual improvement

Some auditors tend to systematically follow the example of their predecessor, which can result in a file mirroring that of the previous year. A better approach would be to document once (in the first year) and then update the existing documentation for changes subsequently.

To continue improving, auditors can look at their existing practices at all planning meetings. Documentation from year one should help auditors in subsequent years to use their understanding of the entity to look at new

industry trends, operational changes, new inherent risks and revised internal controls.

It is also important to consider how file information can best be reviewed this year and in future years. Below are a few points to consider:

Revise the file index

A firm's file index should be updated to incorporate new ISA terminology and processes that are central to the audit.

Document all risks and assessments in one place

Recording risks in one place reduces the chance of missing some. It also helps ensure risks get assessed consistently, makes the file easier to review and allows for the cross-referencing of different risks. Updating risk factors later in the audit and in subsequent years will also be simpler.

Standardize how internal controls will be documented

When documenting internal controls, ensure the link between the risk of material misstatement and the control procedures to mitigate the risks is clear. This lets the file reviewer assess control

design and when changes take place, the impact can easily be identified.

Record audit issues, their resolution and any related communications with management in one place

This can take the form of a summary memorandum. It will ensure important issues are not missed in the file review process and will help subsequent planning.

Good communication between the auditor, management and those charged with governance is important to avoid misunderstandings and develop constructive working relationships (although it is also important for an auditor to maintain his or her independence and objectivity).

It may be worth your time to explain to management what is involved in an audit, the responsibility of the auditor under the ISAs and what management can do to help the audit go smoothly.



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