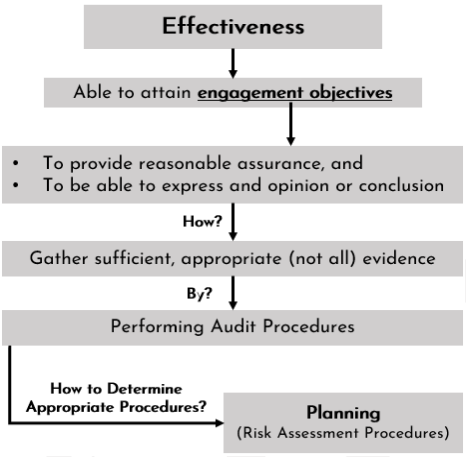
AUDITING (AUD)
CPALE Concept Notes

RISK ASSESSMENT AND RESPONSE
(AUDIT PLANNING AND ROMM)
Source: REO Pre-Recorded (Sir Escala), REO Live (Sir George), and CPAR Lecture (Sir G. Roque)

Topics Covered:

1. *Theory on Auditing and Attestation Services*
   - 1.2. *The Risk-based Financial Statement Audit*
     - 1.2.3. *Scope and purposes of audit planning*
       - 1.2.3.1. *Essential planning requirements*
     - 1.2.4. *Direction, supervision and review*
   - 1.3. *Understanding the Entity and its Environment including its Internal Control and Assessing the Risks of Material Misstatement*
     - 1.3.1. *Industry, regulatory and other external factors*
     - 1.3.3. *Assessing the risks of material misstatement*
     - 1.3.4. *Communicating with TCWG and management*
2. *Auditing Practice*
   - 2.2. *Planning the Audit and Performing Risk Assessment Procedures*
     - 2.2.1. *Risk-based audit – overview*
     - 2.2.2. *Risk assessment – overview*
     - 2.2.4. *Planning the audit*
       - 2.2.4.1. *Overall audit strategy*
       - 2.2.4.2. *Determining and using materiality*
       - 2.2.4.3. *Audit team discussions*
     - 2.2.5. *Performing risk assessment procedures*
   - 2.3. *Risks Response*
     - 2.3.1. *Risk response – overview*
     - 2.3.2. *Developing the risk-based audit plan*
     - 2.3.3. *Determining the extent of testing*

Preliminaries to Risk-Based Audit



Audit Planning

- An iterative, continuous, dynamic process
- Starts after the completion of previous audit engagement
- Ends upon completion of current audit engagement
- Should be designed so that:
  - Audit procedures selected will achieve specific audit objectives
  - Audit evidence gathered supports the auditor's conclusion
- Adequate planning helps ensure that
  - Appropriate attention is devoted to important audit areas
  - Potential problems are identified
  - Work is completed expeditiously

Factors affecting the Nature and Extent of Planning Activities

- Entity's size and complexity
- Previous experience with client
- Changes in circumstances during the engagement
- Timing of appointment

Audit Procedures in an Audit Engagement

- *Risk Assessment Procedures (RAP)*
  - Understanding the entity and its environment
- *Further Audit Procedures (FAP)*
  - Test of Controls (TOC)
  - Substantive Tests (ST)

Preliminaries to Audit Planning

Considerations in Audit Planning *"CRAM"*

- Constraints
  - Time
  - Cost
  - Quality
- Risks
  - AR = IR x CR x DR
    - AR – Audit Risk
    - IR – Inherent Risk
    - CR – Control Risk
    - DR – Detection Risk
- Audit Team
  (partner, manager, senior and junior associates)
- Materiality
  (overall, performance, and specific materiality)

RISKS

Risk of Material Misstatement (ROMM)

- *IR x CR*
- Assessed both at the FS and assertion levels
- Affects the level of detection risk that the auditor may accept

Audit Risk

- The risk that an inappropriate opinion will issue and provide an inappropriate opinion on a materially misstated FS

Likelihood	Magnitude	Inherent Risk Level
Low	Low	Lower Risk
Low	High	Higher Risk
High	Low	Higher Risk
High	High	Significant Risk

- ***Significant Risk*** – risks that require special audit consideration, such as those that involve fraud or complex transactions

Acceptable Level of Audit Risk

- A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued
- A matter of professional judgment
- Based on the extent of reliance placed by the users on the audit work
- ***Audit Risk + Assurance Level = Always 100%***

Reliance on Audit Work	Acceptable Audit Risk	Assurance Level Provided
High	Less than High	High
Less than High	High	Less than High

Inherent Risk

- Susceptibility by nature of an account to material misstatement
- Likelihood that there are material misstatements in an account before considering the effectiveness of its internal controls
- May *(but not should be)* be assessed in quantitative terms

Assessing Inherent Risks

- *General Inherent Risk Factors*
  - Complexity
  - Change
  - Uncertainty
  - Management Bias
  - Subjectivity

- *At the FS (Overall) Level*

External Factor		Inherent Risk Level
Industry *(Inverse)*	Less Stable	High
	More Stable	Low
Regulatory *(Inverse)*	Less Strict *(As to Regulations)*	High
	Stricter *(As to Regulations)*	Low
Other External Factors		

Internal Factor		Inherent Risk Level
Business Objectives *(Direct)*	Lower Objectives	Low
	Higher Objectives	High
Business Risks *(Direct)*	Lower Bus. Risk	Low
	Higher Bus. Risk	High
Measures of Performance *(Cost – Higher Risk of Understatement)* *(Revenue – Higher Risk of Overstatement)*		
Nature of the Entity *(Inventory Approaches, Debt-to-Equity Ratio, etc)*		
Selection of Accounting Policies		
Strategies *(Such as Incentive Programs – Higher Risk)*		

- *At the Assertion Level*

Factor		Inherent Risk Level
Liquidity *(Direct)*	Less Liquid	Low
	More Liquid	High
Difficulty or Complexity *(Direct)*	Less Difficult *(Less Complex)*	Low
	More Difficult *(More Complex)*	High
Frequency of Transactions *(Inverse)*	Less Frequent	High
	More Frequent	Low
Judgment *(Direct)*	Less Judgment Involved	Low
	More Judgment Involved	High

Control Risk

- Risk that controls will not work when needed
- May *(but not should be)* be assessed in quantitative terms
- **At the FS (Overall) Level** – Indirect Controls
- **At the Assertion Level** – Direct Controls (affects the FS)

Components of Internal Control *(CRIME)*

A. *Indirect Controls "**CRIME**"*

1. **Control Environment** *(CHAMPOI)*
   - Provides an ***appropriate foundation for the other components***
   - Includes the governance and management functions, together with the attitudes, awareness, and actions of TCWG and management concerning its internal control (and its importance to the entity)
     - ***Commitment to competence***
       - Updates, standards, trainings
     - ***HR Policies and Practices***
       - Qualification of personnel
     - ***Assignment of Authority and Responsibility***
     - ***Management Philosophy and Operating Style***
     - ***Participation by TCWG***
     - ***Organizational Structure***
       - Duty segregation and check and balances
     - ***Integrity and Ethical Values***
       - The values of the top management may be mirrored by the employees

2. **Risk Assessment Process**
   - *Risk Identification*
     - Identifying the business risks relevant to financial reporting objectives
   - *Risk Assessment*
     - Estimating significance of the risks
     - Assessing likelihood of their occurrence
   - *Risk Management*
     - Deciding about actions to address the risks

3. **Monitoring of Controls**
   - Involves the management's timely assessment of the controls as to its
     - Design, and
     - Operation (implementation)
   - Taking necessary corrective actions modified for changes in conditions
   - May be an:
     - Ongoing monitoring, or
     - Through a separate periodic evaluation

B. *Direct Controls "**CRIME**"*

4. **Information System and Communication**
   - Obtain an understanding of the information system as to ***how transactions are processed up to how the FS are prepared, including significant accounting estimates*** (transaction cycles or business processes)
   - As to what could go wrong in the following:
     - Activities
     - Personnel
     - Source Documents
     - Entries
     - Records

5. **Control Activities**
   - Reasonable assurance or to reduce the chances that the transaction cycles go wrong
   - Policies and procedures to help ensure that management directives are carried out

Based on New List (PARIS)

i. **Physical and Logical Controls**
   - Proper safeguarding of assets

ii. **Authorization Controls**
   - **ALL TRANSACTIONS** need to be authorized before they are executed
     - For small disbursements
       - From petty cash custodian
     - For purchase of inventory
       - Automatic upon reaching certain levels *(and verification of price list)*
   - ***General Authorization*** *(for routine transactions)*
   - ***Specific Authorization*** *(for non-routine transactions)*

iii. **Reconciliations**

iv. **Inspections and Verifications**

v. **Segregation of Duties**
   - Audit evidence as to proper segregation is normally best evidence by ***inquiry and discrete direct observation*** *(direct personal observation may also do)*
   - Incompatible duties "CARE"
     (If delegated to one, such person is places in a position to perpetuate and conceal fraud and/or error)
     - Custody
     - Authorization
     - Recording
     - Execution and Reconciliation
       (repealed in new)

Based on Old List (PIPSA)

i. **Performance Reviews**
   - Comparing expectations to actual results

ii. **Information Processing**
   - Must be valid, complete, accurate, and authorized

iii. **Physical Controls**
iv. **Segregation of Duties**
v. **Authorization Controls**

Detection Risk

- Risk that substantive tests do not detect material misstatements
- May *(but not should be)* be assessed in quantitative terms
- ROMM (IR and CR) is **inversely related** to Detection Risk
  - Higher ROMM (IR and CR) = Must Lower Detection Risk
  - Lower ROMM (IR and CR) = May Increase Detection Risk

Level of Detection Risk	Effects to Substantive Test (Procedures)
Low *(Less than High)*	• ***More effective*** procedures • Performed closer or nearer to ***year-end*** • ***Larger*** sample size
High	• ***Less effective*** procedures • Performed in ***interim or at several dates*** • ***Smaller*** sample sizes

MATERIALITY

- Affected by the size and/or nature of the entity and the engagement
- Based on the consideration of common financial information needs of users as a group (only general, not to specific users)
- A *matter of professional judgment*
- Materiality Level is **inversely related** to both audit risk, evidence needed, and extent of substantive tests

Audit Risk	Materiality Level	Substantive Test	Evidence Needed
High	Lower	More	More
Less than High	Higher	Less	Less

Consideration of Materiality

A. Overall Materiality
(Tolerable Misstatement, General Materiality, or Materiality for the Financial Statements as a Whole)

- Determined at the overall FS level
- Used for the ***formation of audit opinion***, but not for determining which line items or amounts must be audited
- Helps auditor determine *whether the proposed audit adjustments are significant or not*
  - If **within** or did not exceed OM = Unmodified
  - If **exceeded** OM = Qualified
- ***May be changed*** due to changes in circumstances of the engagement *(not static)*
- ***OM = Appropriate Benchmark x Appropriate %***
  - Benchmark must be ***an element or component of an FS*** *(based on the users' needs)*, which could be net income, total assets, working capital, shareholders' equity, among others.
  - If there are no year-to-date or year-end FS, *interim FS* may be annualized, or the *prior year FS* may be utilized *(subject to changes)*
  - ***Laws and regulations***, together with the ***nature of the entity*** must also be considered

Example:

Total Assets	*= 1,000,000*
Overall Materiality	*= 10% of Total Assets* *= 10% of 1,000,000* ***= 100,000***

B. Performance Materiality *(Planning or Scoping Materiality)*

- Lower than the overall materiality
- Takes into consideration the *Detection Risk*
- Used to ***determine the scope*** or as to which line items or amounts must be audited
- Ensures that detected AND undetected misstatements will not exceed the overall materiality
- ***PM = OM x Certain %***
  - Arrived by subtracting a **"haircut"** from the overall materiality
  - The higher the risk, the higher the needed haircut, lowering the performance materiality level

Example:

Overall Materiality	*= 100,000*	
Higher Risk	*= 40% Haircut*	
Lower Risk	*= 20% Haircut*	
OM	*100,000*	*100,000*
Haircut	*(40,000)*	*(20,000)*
Performance Materiality	***60,000****	***80,000****

** Accounts 60,000 and above shall be tested (higher risk)*
** Only accounts 80,000 and above shall be tested (lower risk)*

C. Specific Materiality *(Individual Materiality)*

- Specific items that should be tested, which did not meet the performance materiality level

Example:
Specific Materiality of Cash and Gov't Related Transactions is set at 1 peso

PSA 300 – Planning an Audit of Financial Statements

Planning an audit involves:

- Establishing the engagement's ***overall audit strategy***, and
- Developing an ***audit plan***

OVERALL AUDIT STRATEGY

- Sets the scope, timing, and direction of the audit
- Guides the development of the more detailed audit plan

Considerations for the Establishment of Overall Audit Strategy

- Characteristics of the Engagement
  - Financial reporting framework
  - Industry-specific reporting requirements
  - Location of entity components
- Reporting Objectives
- Timing of the Audit
- Nature of the Communications Required
- Significant or Important Factors that will determine the engagement team's focus of efforts
- Preliminary Engagement Activities and Knowledge Gained on Other Engagements
  - Appropriate materiality level
  - Preliminary higher ROMM areas, material components, and account balances
- Nature, Timing, and Extent of Needed Resources
  - Selection of engagement team members
  - Assignment of audit work to team members
  - Engagement budgeting

AUDIT PLAN

Includes a description of the following:

- Nature, timing, and extent of Risk Assessment Procedures
- Nature, timing, and extent of Further Audit Procedures
- Other Planned Audit Procedures required by PSAs

Generally modified when the results of the test of controls differ from the expectations

AUDIT PROGRAM

- Serves as instructions to assistants involved and as a means to control and record proper execution of work *(proof that audit work is adequately planned and documented)*
- Generally, contains the following:
  - Audit objectives for each area
  - Nature, timing, and extent of audit procedures required to implement the overall audit plan
  - Time budget for various audit areas or procedures

Direction, Supervision, and Review

The nature, timing, and extent of direction, supervision, and review of team members and their work vary depending on:

- Size and complexity of the entity
- Area of audit
- Risks of material misstatement (ROMM)
  - Main source of planned direction, supervision, and review

Higher ROMM	More Extensive and Timely Direction, Supervision, and Review
Lower ROMM	Less Extensive and Timely Direction, Supervision, and Review

- Individual team members' capabilities and competence

PSA 315 – Identifying and Assessing the Risk of Material Misstatements (Through Understanding the Entity and Its Environment)

AUDITOR'S OBJECTIVES IN ROMM ASSESSMENT

- Identify and assesses ROMM at two levels:
  - At the FS Level
  - At the Assertion Level
    - Audit Risk Model (AR = IR x CR x DR)
      - If ROMM is high, DR must be lowered
      - If ROMM is low, DR can be increased
- Providing a basis for designing and implementing responses to the assessed ROMM

Risk Assessment Procedures (RAP)

Designed and performed to obtain audit evidence providing appropriate basis for:

- The identification and assessment of ROMM at the FS and assertions levels
- The design of further audit procedures

RAP's Specific Audit Procedures

1. **Inquiry**
   - To management and those responsible for reporting
   - To others within the entity and other employees
     - Those charged with governance (TCWG)
     - Internal audit
     - In-house legal counsel
     - Marketing or sales
     - Those involved in initiating, processing, or recording complex or unusual transactions
2. **Observation**
   - Activities, operations, and processes used in processing information to be reported
   - Only to obtain understanding of the entity
3. **Inspection**
   - Both documents and tangible assets
   - Includes the following:
     - Prior FS and working papers
     - Manuals
     - Minutes of the meeting
     - Management reports
     - Industry-related publications
     - Visitation of premises and plant facilities
4. **Analytical Procedures** *(PSA 520)*
   - Analyzes *plausible relationships* among *financial and non-financial* data to help identify existence of ***unusual transactions or events***
   - Excludes *error projection (sampling procedure)*
   - *May be omitted for substantive testing, but may not be omitted entirely for an FS audit*

	Required?	Objective
Planning	✓	To identify specific risks (ROMM)
Substantive Tests	✕	To detect material misstatements
Overall (Final) Review	✓	To assess validity of conclusions reached

   - Analytical procedures alone, may provide the appropriate level of assurance for some assertions
   - Develops then compares expectations, and define and investigate significant differences

Primary FS to Develop Expectations *"PAA"*
(for both risk and materiality)

- ***P***rior Year FS
- ***A***nnualized Interim FS
- ***A***nticipated Results *(Budgets, Forecasts, Projections)*

Secondary and Other FS Considered to Develop Expectations *"RIN"*

- Typical ***R***elationships among FS Account Balances
- ***I***ndustry Averages
- ***N***on-Financial Information

Examples of Analytical Procedures:

- Variance Analysis
- Trend Analysis
- Ratio Analysis
- Scan Journal Entries

Other Planning Considerations

- **PSA 620 – Determining the Need for an Auditor's Expert**
  - *May or may not use* the work of an expert, other than those in accounting or auditing
  - Must evaluate the expert as to his:
    - Competence
    - Capability
    - Objectivity
  - ***Internal experts are preferred*** over external ones, but no restriction as to opting for an external expert
  - Experts *do not need to be independent* of the client, only the auditor needs independence
  - Must consider obtaining an understanding of the expert's field of expertise, including the ***methods and assumptions*** he used
  - If auditor determines that *expert's work is not adequate* for the audit, he shall resolve the matter by ***performing additional audit procedures*** appropriate for the circumstances

Subsequent Unmodified Opinion	Auditor shall *not refer* to the expert's work
Subsequent Qualified Opinion *(Any Modification to his opinion, as long as not Unmodified)*	Auditor shall *make reference* to the expert's work *(as long as related)* But, ***auditor's responsibility to the opinion is not reduced***

- **PSA 550 – Related Parties**
  - Auditor's primary concern: ***Proper Disclosure***
  - The auditor shall inquire the management as to:
    - Related parties' identity
    - Nature of relationships
    - Existence of transaction with related parties, and its ***type and purpose*** *(with its effects and extent)*
  - Auditor shall consider the possibility of undisclosed related parties *(remain alert)*
  - Example *indicators* of undisclosed related parties:
    - Guarantees
    - Borrowing at ***significantly*** below the market rate

- **PSA 610 – Internal Auditors' Work**
  - Internal auditors *may* provide direct assistance to external auditors
  - The work performed by the internal auditors *may* be a factor in determining the nature, timing, and extent of the external auditor's procedures ***(The external auditor remains as the decision-maker)***
  - Must consider or evaluate them as to their:
    - **Objectivity**
      (Reporting Status, TCWG Oversight)
      - Should be reporting to the BOD/TCWG, specifically the *Audit Committee*
    - **Competence**
      (Educational Level, Profession Experiences, Working Papers, Hiring Policies, etc.)
  - If any between objectivity and competence is not met, less or no reliance of their work will be made

- **Considerations to Smaller Entities**
  - Audit strategy for small entity audits *need not to be a complex* or time-consuming exercise
  - Varies according to the audit's complexity, and the size of the entity and the engagement team

- **Other Matters**
  - Staffing decisions *may change* all throughout the engagement
  - Engagements may be accepted even after the client's financial year-end *(actually the usual practice)*
  - A portion of audit of a continuing client can be performed at interim dates