

Solutions to Student Self Assessment Questions

Chapter 5

The risk-based approach to audit: audit judgement

Questions

5.1 This question was addressed in the text

5.2. Consider the following statements and whether they might be true or false. Provide explanations with your answers.

- a) The directors of the client company sign the audit engagement letter.
- (b) The auditor must always discover fraud and other irregularities.
- (c) Fees of the auditor are based on the time taken and the grade of staff involved in the assignment.
- (d) A business risk approach by auditors is wider than the audit risk approach.

5.3 The audit firm consists of a collection of individuals with varying degrees of experience and expertise. Briefly describe the role that individual staff members play in achieving audit objectives.

5.4 You are the senior in charge of the audit of a local newspaper and have been asked by your audit assistant to explain what kinds of income and expenditure can be expected to arise in the company. She is also anxious to know if there are any particular problems that might be faced by management and, therefore, the auditor. Think of problems such as reporting on circulation of the newspaper to government or independent bodies and maintenance of circulation.

5.5 Discuss briefly the following statements (in doing this, try to go beyond the text of this chapter and use your imagination to explore the statement).

- (a) Audit risk is the risk that control systems will not detect material misstatements in the financial statements subject to audit.
- (b) Cumulative client knowledge enables the auditor to be more efficient and aids effectiveness in the audit process. Explain what you understand by cumulative client knowledge. Ask yourself what information about an organization would be useful to you on a permanent basis.
- (c) The letter of engagement is of little value, as most clients will not understand what it means.

Solutions

5.1 The solution to this question appeared in the text

5.2 a) *True*

The important thing is that both auditors and client are aware of, indeed have a full understanding of, the nature of the assignment and the rights and duties under it. The statement is, of course, only partially true. The fact is that both directors and auditor should sign the letter, the auditor at the time of sending the letter and the directors or their representative, at the time of returning it. There is no reason why the client should not send the letter in the first place, but normally it is better

that it be drafted by the professional firm. It would, of course, be necessary to discuss it in detail with the directors before it is finalised.

b) *False*

There is much discussion about the auditor's duty with regard to detection of fraud and other errors and we shall discuss this in detail in Chapter 17. Basically, the auditor is required to focus on areas where there is risk of material misstatement because of fraud, including management fraud and to maintain an attitude of professional scepticism throughout the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. (See paragraph 4 of ISA 240 - The Auditor's Responsibilities relating to fraud in an Audit of Financial Statements).

c) *True*

The basis of charging fees must be such that the auditor is, and is seen to be, independent. The preferred basis for charging fees is time taken and grade of staff engaged. Some firms charge on the basis of a so-called 'balanced audit team'. Recently there has been much more openness in setting fees with large firms tendering at fee levels considerably less than only a few years ago.

d) *True*

To some extent inherent risks, which form one component of audit risk, are similar to business risks in that they need to be subjected to management controls to alleviate their impact. Business risks are those risks that may make it difficult to achieve management objectives. For instance, an hotel might have a preferred room occupancy rate to achieve desired levels of profitability. We have already seen in this chapter that management may introduce management information systems on such matters as rooms currently unoccupied and peaks and troughs of occupancy. This information is a form of control and would be used to inform potential customers whether rooms are available and to enable them to put in a strategy to increase room occupancy at less busy times. For auditors, knowledge about how the company controls business risk in this area, would be an important element in work designed to prove that accommodation income appearing in the profit and loss account was true and fair in the context of the financial statements taken as a whole. However, inherent risk approaches are more limited than business risk approaches as they are directed to the financial statements in the context of the auditors' opinion on the financial statements. However, business risk approaches are designed to aid management in achieving business objectives, of which the preparation of fairly presented financial statements would only be one. Thus, it is true to say that a business risk approach by auditors is wider than the audit risk approach.

5.3 In Figure 3.3 on page 81 of the text we showed all of the individuals and functions involved in the provision of audit work. These include the members of the engagement team comprising:

- the Engagement Partner (who has overall responsibility for the assignment)
- Manager in charge of the assignment (who has overall responsibility for supervising the assignment, staying in close contact with the Engagement Partner and the other members of the Engagement Team)
- Other audit staff, including people with varying degrees of experience – the senior in charge who will be present throughout the assignment - and staff with less experience such as semi-senior or junior staff whose work will be closely supervised.

- Other professional staff with special skills, including IT and tax experts, who will be used at particular points of the audit work.

Apart from members of the Engagement Team, there are other individuals and functions that play a role in achieving audit objectives. These include:

- Staff providing a technical advisory services, such as advice on the application of accounting and auditing standards
- Ethics Partner who advises the Engagement Partner on possible threats to independence, including possible breaches of the firms ethical guidelines.
- Engagement Quality Control Reviewer who is there to ensure that high standards are maintained during and at the end of the audit process. This person may review working papers and act as intermediary in the event of disagreement between the Engagement Partner and the Ethics Partner.
- Others in the Audit Firm's chain of command, including those at the top of the firm who are responsible for the Firm's Control Environment.

It is important to note that the activities of the firm must be organised to produce the professional service when it is required. It is quite likely, for instance, that there will be a partner in charge of the computer/IT services and of the taxation services. In preparing the audit plan, approaches will have to be made to the specialist services to ensure that their staff will be available when required. It will also be desirable that the person in charge of the typing services is aware of deadlines and other reporting requirements (for instance, complicated diagrams and layouts) on a timely basis.

5.4 Typical income in a company publishing a newspaper:

- Sale of newspapers: Office sales, Newsagent sales, Street sales
- Sale of advertising: Classified advertising, Block advertising (Prominent advertising of commercial and official material)
- Sale of photographs
- Games and competitions entered by the readership

Typical expenditure of a company publishing a newspaper:

- Newsprint
- Inks of various colours
- Sundry printing costs, including repair and maintenance of printing machinery
- In a company using the latest technology, we would expect to find both capital and revenue costs associated with the technology
- Salary and wage costs of: Editorial staff, Reporters, Photographers, Copy readers, Delivery people. Advertising department staff (including classified advertising staff dealing direct with the public, and designers and setters of larger advertisements), Administration staff
- Expenses connected with obtaining stories and photographs
- Distribution costs, including delivery van costs (petrol, servicing, depreciation of vans etc.)
- Payments to free-lance writers
- Payment of prizes to the winners of games and competitions.

Possible problem areas for management and auditor:

- Reporting on circulation of the newspaper to government or independent bodies. The average sales over a period of time represent actual sales (not print runs), so it is important to reconcile print runs with recorded sales. Typical reasons for differences between print run and quantities sold will be: copies given to editorial and other staff, free copies given to libraries and other organisations, copies not sold, either by own staff or newsagents. There should thus be control over copies

returned for pulping. The auditor would have to find out if it is company policy not to charge newsagents for returned copies.

- Maintenance of circulation. This normally has a correlation with advertising and the auditor would find circulation and advertising statistics produced by management for their own purposes, useful sources of evidence.
- Control of advertising to the newspaper. Classified advertising consists of many hundreds of transactions each time the newspaper is produced. The control of advertising is complicated by the fact that there are often special rules where an advertisement is placed several times in the paper: 'One free for every three placed', for instance. Management will have to institute tight systems of control, not only to ensure that the advertisement appears in the correct form and in the desired issue of the paper, but also that the income has been completely and accurately recorded. The auditor will investigate the operation of the control system, but, like management, should be able to substantiate total advertising revenue on a global basis. Each page of classified advertising should be valued for each issue and reconciled to revenue. The auditor can do this sort of check on a test basis.
- Control over expenses of reporters, photographers and other members of staff will require the drawing up of detailed rules and internal checks to ensure that the rules are adhered to. The auditor would test the system of control to ensure it is working properly and check a selection of expense reports to ensure the expenditure has been incurred by the staff member, that the amounts are in accordance with predetermined rules and that they have been agreed by responsible officials.

This review of newspaper income, expenditure and management and control problems has touched upon typical matters and is not intended to be complete. What is important for the auditor is to understand how to approach audit assignments, even in unusual industrial and commercial sectors.

- 5.5 a) Failure by control systems to detect material misstatements in the financial statements subject to audit will of course increase audit risk, but audit risk is affected not only by control risk, but also inherent and detection risk. The statement in the question was designed to help you to understand the nature of audit risk. As we made clear in the text, audit risk is a concept that has been receiving greater notice in recent years and it is important that you should understand its significance. The statement is therefore incomplete. Control systems should be designed to mitigate the impact of inherent risk and the auditor should review control systems to ascertain whether they are likely to detect material error and irregularity deriving from inherent risk. After considering the levels of inherent risk and control risk, the auditor determines the scope of examination in order to reduced detection risk to acceptable proportions.
- b) Cumulative client knowledge is all the continuing useful information about the Client Company, collected by the auditor during association with the company. Much of this information will be included in working papers and correspondence files, but some of it will be in the minds of people. Typical useful knowledge will include:
- Key personnel: details of position, experience and background; personality and management style
 - History of company, its position in the industry/commercial sector and its strategy to reduce risk and to meet the problems of the industry
 - Products and their nature, major customers and suppliers
 - Particular audit problem areas and how the problems were solved in the past

- Details of systems in use and the number of transactions they process during an average week/month/year.

All audit firms try to keep permanent records of cumulative client knowledge, by, for instance, requiring the senior to copy all matters of permanent interest from the current year's working file and correspondence files to a permanent file. Correspondence between the client company and the bank on new and stringent arrangements for control of the bank overdraft would be a typical item to be kept permanently. It must be said that keeping the permanent file up to date and uncluttered with irrelevant material needs considerable discipline on the part of the auditor, although this is probably easier where the audit firm is using computerised audit files. It is human nature to move to the next assignment without dotting the i's and crossing the t's on the previous one. That cumulative client knowledge is important is not to be doubted. To acquire knowledge is an expensive business, and if you are collecting the same knowledge year after year, you not only run the risk of upsetting the client staff, you also make the audit process much less efficient and profitable than it should be.

The other matter of importance is the question of effectiveness. The *raison d'être* of the external auditor is the professional one of giving an opinion on the truth and fairness of financial information. In attaining the professional objective, the auditor has to obtain sufficient, appropriate (relevant and reliable) information. If the audit firm has not maintained cumulative client knowledge properly in previous years it is likely that the auditor will be less effective in the current year.

- c) If the client does not understand the letter of engagement and can prove that the auditor did not explain it properly to them, the letter might indeed be said to be of little value. A court might well take the view that the auditor had merely produced a document to protect him or her and that the client had a legitimate expectation that the auditor had not fulfilled.

The letter of engagement should be seen as the document setting the scene for the future relationship between auditor and management. It should be relevant to the company being audited and should be discussed paragraph by paragraph with the client before signature. The client should have the opportunity to suggest amendments and to have any matter explained that is not understood. The statement in the question should be rejected.