

Define and Explain:

- **Risk**
 - Auditors try to reduce the risk (probability of something going wrong) by carefully managing the engagement
 - The risk that an auditor will not discover errors or intentional miscalculations (i.e. fraud) while reviewing a company's or individual's financial statements
- **Materiality**
 - Materiality is the largest amount of uncorrected misstatement that might exist in financial statements that still fairly present the company's financial position and results of operations.
 - Misstatements are material if a users decisions would be changed
 - Matter of professional judgment
 - Based on surroundings and size and nature - Includes omissions
 - Based on common financial information need of users – possible specific users needs are not considered
 - Unimportant errors do not affect users, cost vs. benefit analysis
 - Assume that users have reasonable knowledge of business and accounting
 - Determines nature timing and extent of risk assessment and audit procedures
 - Qualitative vs. Quantitative
 - Qualitative materiality is important because an omitted disclosure may not have a dollar sign amount, but may affect a user's decision
 - Some benchmarks (normalize/average income measures):
 - 5% of income from continuing operations
 - 5% of net income before bonus
 - ½ to 2% of revenues or expenses for NFP organizations
 - ½ to 1% of net asset value for the mutual fund industry
 - 1% of revenue for the real estate industry
 - **Performance Materiality** - amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatement exceeds materiality for the financial statements as a whole – acts as a cushion for auditor
 - Aggregate misstatements may cause financial statements to be materially misstated and leaves no margin for error
 - Intentional misstatements, violations of the law and earnings management are considered material, no matter what amount
 - Small misstatement that can be material if they:
 - Mask a change in earnings or other trends,
 - Hide a failure to meet analysts' consensus expectations for the client,
 - Change a loss into net income or vice versa,
 - Concern a segment of the business that is considered significant,

- Affect the client's compliance with regulatory requirements,
 - Involve concealment of unlawful transactions, or
 - Have the effect of increasing management compensation.
 - If material items are not corrected, reservation required
 - Need written representation from management that the effect of uncorrected misstatements are immaterial - attach summary to the representation
- **Significant Risk**
 - An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration
 - Non-routine transactions, judgment involved, unusual due to size or nature – manual intervention for accounting treatment, complex calculations
 - Risk of fraud?
 - Controls must be tested in current period using substantive procedures and tests of details
 - Substantive procedures – reconcile financial statements to accounting records and audit all material journal entries
- **Professional Skepticism**
 - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence
 - Circumstances may exist that will make the financial statements materially misstated
 - Question contradictory audit evidence and reliability of documents
 - If documents are questionable, auditor must investigate further and may need to do additional audit procedures
- **Independence**
 - Must not only be independent, but also appear independent to others
 - Unbiased and objective state of mind
 - Independence is the condition of mind and circumstance that would reasonably be expected to result in the application by a member of unbiased judgment and objective consideration in arriving at opinions or decisions in support of the member's report.
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- **Prohibition**
 - Circumstances and activities which members and firms must avoid when performing an assurance engagement, because adequate safeguards do not exist that would, in the view of a reasonable observer, eliminate a threat or reduce it to an acceptable level
 - Ownership in an assurance client (financial interest)
 - No adequate safeguards available
 - Loans/guarantees
 - Recent employment
 - Creation of source documents (journal entries)

- Management functions
 - Legal and bookkeeping/accounting services
- **Safeguards**
 - Measures that are preventative in nature. There are three categories:
 - Safeguards created by the profession, legislation or regulation
 - Education, training, practical experience, professional standards, disciplinary process
 - Safeguards within the assurance client
 - Competent employees, client's policies and procedures, a client's audit committee
 - Safeguards within the firm's own systems and procedures
 - Firm-wide policies and procedures regarding independence, rotation of senior personnel
- **Threat**
 - Five categories of threat to independence:
 - Self-Interest Threat
 - Benefit from financial interest or self-interest conflict
 - Having financial interest in client
 - Self-Review Threat
 - Product/judgment from previous engagement must be evaluated
 - Advocacy Threat
 - Firm/auditor promote an assurance client's opinion to the point that objectivity may be impaired
 - Promoting shares of assurance client
 - Familiarity Threat
 - Auditor becomes too sympathetic to client's interests due to close relationship with client/ employees
 - Intimidation Threat
 - Auditor deterred from acting objectively or exercising professional skepticism by threats (actual or perceived) from assurance client
 - Threat of being replaced over account principle disagreement
- **Professional Judgment**
 - A professional reaching a complex decision by incorporating standards and ethics in a coherent manner
 - Think of all possible reasons for something to have occurred
 - Critical thinking

Important Topics

- CAS – Canadian Auditing Standards by CICA
- Independence – be able to respond to scenarios

- Fraud, error, illegal acts
 - Intentional vs. unintentional misstatement
 - Fraud – An intentional act by one or more individuals among involving the use of deception to obtain an unjust or illegal advantage
 - Fraudulent financial reporting
 - Manipulation, falsification, alteration of records
 - Misapplication of GAAP
 - Overriding internal controls
 - Misappropriation of assets
 - Embezzling, stealing, personal use
 - Motivation, Perceived Opportunity, Rationalization
 - It's the Board's primary responsibility (management)
 - Auditor must obtain reasonable assurance that free of fraud/errors
 - Use professional skepticism and perform risk assessments – incorporate element of unpredictability
 - Areas of high risk: banking, investing, mining, pollution
 - **Direct-effect illegal acts** have direct and material effects on financial statement amounts and they are dealt with in the same manner as errors and irregularities.
 - **Indirect-effect illegal acts** refer to violations of laws and regulations that are far removed from financial statements.
 - Dangling debit - an asset amount that is investigated and found to be false or questionable
- Going concern issue
- Revenue recognition – audit issues
- Risk assessment procedures (do not provide sufficient appropriate audit evidence on their own)
 - Inquiries of management and employees
 - Analytical procedures (unusual data and relationships)
 - Observation and inspection (operations, reports, records)
- **Audit risk** is the probability that an auditor will fail to express a reservation (modification) in the audit report that the financial statements are materially misstated
 - Inherent risk
 - Control risk
 - Detection risk
- Reasonable assurance
- Planning
 - Objective: to perform the engagement in an effective manner
 - Use analytical procedures as risk assessment procedures
 - General understanding of legal and regulatory framework and whether entity is complying
 - Determination of materiality

- Establish overall audit strategy (scope, timing, approach)
 - Develop plan to reduce audit risk to acceptably low level
 - Time budget
- Understanding the entity
 - Need to understand the auditee's business risks, management's strategy to address risks and business processes used to implement strategy
 - Relevant industry, regulatory, operations, ownership, investments made, structure, accounting policies and how it's financed
- Internal control and communications of weaknesses
 - Process to provide reasonable assurance about the achievement of an entity's objectives with regards to the reliability of financial reporting, effectiveness and efficiency of information and compliance with laws
 - Components:
 - Control environment
 - Entity's risk assessment process
 - Information systems
 - Control activities relevant to the audit
 - Monitoring of control
 - Consider: control over asset safeguarding, accuracy of information
 - Inherent limitations of internal controls:
 - Human judgment and the realities of human error
 - The operation of a control may not be effective
 - Controls can be circumvented by collusion
 - Management decisions about the design/ implementation of controls and the risks it assumes
 - The auditor may request management to provide a written representation that it has communicated all deficiencies in internal control of which management is aware
 - If auditor find significant deficiencies, he shall communicate in writing to those charged with governance
 - Deficiency: A control is designed, implemented or operated in such a way that is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis
- Client acceptance
 - Accounting firms are not obligated to accept undesirable clients, nor retain existing audit clients.
 - Can the audit be performed at a reasonable cost?
 - Are financial statements in accordance with GAAP?
 - Does management understand responsibility for preparing financial statements and designing and implementing internal controls
 - Contact predecessor auditor to see if there are any issues
 - Obtain engagement letter before commencing
- Client acceptance/retention

- Evaluation of independence
- Firm's expertise
- Other experts
- Timing of audit – would staff be available
- Billing rates – expected return to firm
- Audit environment – SOX
 - Reaction to Enron failure
 - Created the Public Company Accounting Oversight Board (PCAOB) – tighten quality control of audit practices
 - Management must certify financial reporting and audit report on internal controls must be produced
 - CPAB – Canadian Public Accountability Board
- Public interest
- Audit procedures in response to risk assessment
 - Use professional skepticism and more staff and supervision
 - Modify procedures
- Analytical procedures – your examples should be actual procedures
 - Def: Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data
 - Auditors like them because they are cheap!
 - Easy to conduct, easy to compare to previous years
 - Makes flagging inconsistencies easier
 - Used during the planning, testing and overall review stages
 - Horizontal analysis – comparison of changes in financial statement numbers and ratios across 2 or more years
 - Wages expense over last 2 years
 - Vertical analysis – comparing all financial statements to a common base
 - Rule of thumb: follow up on differences that are 20% of materiality
 - Examples:
 - Gross profit analysis, comparison of expenses between periods, sales by geographic region, by customers, by products
 - Comparison to industry averages
 - Comparison to budgets
 - Analysis of sales ratios

Notes:

- Auditing in financial reporting is a process of reducing (to a socially acceptable level) the information risk to users of financial statements by having a third party verify the information
 - Auditor lends credibility to the financial information (provides assurance to the reliability of the information)
- “The objective of the audit of financial statements is to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework”
- “Reasonable Observer — a hypothetical individual who has knowledge of the facts, which the member knew or ought to have known, and applies judgment with integrity and due care.”
- Audits may act as deterrent – threat of discovery
- Assurance services are independent professional services that improve the quality of information, or its context, for decision makers
- Principles necessary to attain objective (serve the public interest):
 - Integrity – honest and conscientious
 - Objectivity
 - Professional Competence and due care
 - Confidentiality
 - Professional behaviour
- Opening Balances
 - Objective: To obtain sufficient appropriate audit evidence about whether:
 - Opening balances contain misstatements that materially affect the current period’s financial statements; and
 - Appropriate accounting policies have been consistently applied in the current period’s financial statements, or changes are appropriately accounted for and adequately presented and disclosed
 - Check to see if closing balances properly carried forward and if opening balances reflect application of GAAP
 - Check predecessor auditor’s working papers to obtain evidence regarding opening balances
- Earnings Management (EM) usually involves accounting estimates (liabilities, depreciation, reserves, etc.) may result in materially misstated statements
- **Professional judgment** is required regarding decisions about:
 - Materiality and audit risk
 - Nature, timing and extent of audit procedures
 - Evaluating whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the CASs
 - The evaluation of management’s judgment in applying the entity’s applicable financial reporting framework
 - The drawing of conclusions based on the audit evidence obtained
- Confirmations

- Positive – require response if balance is correct or incorrect
- Negative – require response if balance incorrect
- Can be used to uncover AR lapping
- If auditee does not allow confirmations – alternative procedures, or possible scope limitations. May indicate cover up of fraud
- Business risk
 - Significant conditions, events, circumstances or actions that might adversely affect the entity’s ability to achieve its objectives and execute its strategies
- Reports
 - Modified reports (Reservations)”
 - GAAP departure or scope limitation in separate paragraph
 - “Except for…” wording in the opinion paragraph
 - Financial statements are still useful when read with modified report
 - Unqualified – clean report – not materially misstated
 - Qualified – not in accordance with GAAP, but no misrepresentations
 - Adverse – not in accordance with GAAP, financial records misrepresented. Worst type of report
 - Disclaimer – opinion on financial status cannot be determined
 - Very significant scope limitation
 - Financial statements may not be presented fairly
 - Components
 - Introductory paragraph
 - Management’s responsibilities
 - Auditor’s responsibilities
 - Description of audit
 - Opinion

