Chapter 5–Overview of the Audit Process

Chapter 5 provides an indispensable overview of the entire audit process that one must appreciate to have a grasp of the "big picture" and not get mired down in too much detail. Let us take a close look at Fig. 5-1 on page 163 to visualize the "big picture" view of an audit.

Let's work our way through each of these important areas:

Knowledge of the Business and Industry

SAS 22 tells us that knowledge of the client's business and industry is a significant component of audit planning. Many large accounting firms develop expertise in auditing particular industries. Such specialization allows an accounting firm to deliver a higher quality audit to clients.

It is critical to develop expectations of financial statements for a firm in a given industry. Awareness of economic and industry trends is vital for developing a sense of economic context within which a client firm operates. These trends may help explain certain account trends or deviations detected on the financial statements. Moreover, awareness of factors, trends, etc. unique to an industry allows an auditor to better assess the risks facing a particular client.

Moreover, knowledge of a client's industry and business puts the auditor in a better position to understand information system issues that impact clients. The software systems used by country clubs vary considerably from those used by health care companies. An auditor needs to develop an understanding of how specialized accounting software packages work for given types of businesses to be able to conduct more effective and efficient audits.

The ability to develop sound accounting estimates of reasonableness is enhanced by a high level of business and industry knowledge. For example, knowledge of what is a reasonable valuation for a loan loss reserve allowance for a commercial bank requires refined professional judgment. Such judgement is obtained primarily from experience and to a lesser extent education.

Also, let us not forget that specific GAAP apply only to certain industries. The AICPA has developed industry accounting and audit guides for particular industries to assist those trying to gain knowledge about those industries.

Management's Financial Statement Assertions

SAS 31 says there are 5 types of management assertions:

1--existence or occurrence

2--completeness

3--rights and obligations

4--valuation or allocation

5--presentation and disclosure

Materiality

Materiality recognizes that some accounting issues are significant for fair presentation of the financial statements while others are not. The context for making a professional judgment about what is material to the financial statements is the auditor's understanding of the nature and magnitude of misstatement that would influence the decisions of a user.

The concept of materiality affects the audit process in the following ways:

1–the auditor makes a judgment about materiality while planning the engagement to make important decisions about audit scope

2–the collection of sufficient, competent evidence

3–in assessing the significance of audit evidence with regard to audit findings

Audit Risk

Audit risk is the likelihood that an auditor will unknowingly fail to appropriately modify his or her opinion on materially misstated financial statements. Materiality must be established before risk has any meaning.

AR= IR x CR x DR

The three components that make up audit risk all relate to management assertions.

IR= Inherent Risk--the susceptibility of an assertion to a material misstatement assuming no internal control policies or procedures. The professional standards indicate that an auditor should consider factors affecting risk similar to those listed in SAS 99 . The risk factors you learned for SAS 99 are now paying you a dividend!

CR=Control Risk--the risk that a material misstatement that could occur in an assertion will not be prevented or detected by the entity's internal controls. Control risk cannot be zero.

DR=Detection Risk--the likelihood that an auditor will not detect a material misstatement in an assertion. It is a function of the effectiveness of auditing procedures.

<u>Relationship Between Audit Risk and Evidence</u>

Application of the logic of the audit risk model allows the auditor to make decisions about the nature, extent, and timing of audit procedures for a given assertion. Let's follow the steps an auditor might take in this process:

1–assessment of likelihood that a material misstatement will occur in an assertion

2–gaining an understanding of the entity's internal controls relevant to an assertion

3–consideration of the inherent and control risks and making a subsequent judgment about the risk of material misstatement in the financial information about the assertion that is presented for audit

4–the concept of audit risk is consistent with the fact that the audit is designed to provide reasonable not absolute assurance that the financial statements are free of material misstatements

<u>Audit Evidence Decisions</u>

Every auditor must determine the appropriate amount of evidence to collect to be satisfied that the components of the financial statements and the overall statements are fairly stated.

The auditor's decisions on evidence accumulation can be broken down into:

1-which audit procedures to use

Audit procedures--detailed instructions for the collection of a particular type of audit evidence. Examples:

2--what sample size to select for a given procedure
3--which items to select from the population

If an auditor decides to select 200 canceled checks from 10,000 to compare to the cash disbursements journal, several different methods can be used to select the checks.

4--when to perform the procedures

Audit program--the detailed description of the results of the four evidence decisions for a specific audit. An audit program always includes a list of the audit procedures.

<u>Persuasiveness of Evidence</u>

The third standard of field work requires the auditor to accumulate sufficient competent evidence to support the opinion issued. The 3 determinants of the persuasiveness of evidence are:

1--competence (or reliability of evidence)

The six characteristics of competent evidence are:

1--relevance--evidence must pertain to the objective being tested.

Example:

2--independence of provider of evidence

a) evidence obtained from a source outside the entity is more reliable than that obtained from within

3--effectiveness of client's system of internal control

4--auditor's direct knowledge

5--qualifications of individuals providing the information

Example:

6--degree of objectivity

2--sufficiency--this refers to the quantity of evidence obtained

a) sample size is important in determining sufficiency

b) the particular items tested affect sufficiency

3--timeliness--refers to when the evidence was accumulated or the period covered by the audit

The persuasiveness of evidence can only be assessed after considering the combination of competence, sufficiency and timeliness.

<u>Audit Procedures Classification</u>

1. Procedures to obtain an understanding

2. Tests of controls

3. Substantive tests

Dual-purpose tests--are those tests that jointly evaluate internal control policies and procedures and details of account transactions.

Evaluation of evidence obtained

An auditor needs a preponderance of persuasive evidence for each material financial statement assertion to have a reasonable basis for an opinion. When a reasonable basis exists an unqualified, qualified or adverse opinion will be issued. If no reasonable basis exists then a disclaimer of opinion will be issued.