

Using Canadian Auditing Standards (CASs) to your advantage

Every year, the practice inspection reports issued by the provincial and territorial CPA bodies contain similar issues related to auditing standards. And every year, many auditors look at the list and wonder about the purpose of these requirements—especially for smaller, low risk audits.

Canadian Auditing Standards (CASs) are set first and foremost with the public interest in mind. Consistently good audits add significant credibility to reported financial information. The standards are designed to reduce engagement risk to an acceptably low level, which also helps auditors manage their engagement risk. Following the standards is therefore a win-win situation for both statement readers and auditors alike. The trick is to do so effectively **and** efficiently.

Four areas of standards compliance—i.e. testing journal entries, reviewing subsequent events, evaluation of design and implementation of internal controls and looking at revenue recognition from a fraud risk perspective—repeatedly come up in inspection findings as auditor deficiencies. It is helpful to look at the audit requirements in these areas through the lens of risk management and engagement efficiency to see how auditors can use them to their advantage:

1. Testing journal entries

What CASs require:

Auditors must test journal entries made in preparation of financial statements for evidence of management override of control (CAS 240.32). The focus is on fraud.

Effectiveness:

This is a sensible requirement, especially for audits of entities with large accounting departments. Unusual journal entries at year-end can be an indicator of issues in the accounts; the absence of them can be an indicator that the accounts are in good shape. Either way, the review is a useful procedure to reduce audit risk. But is it a useful requirement for audits of very small entities where, in some cases, all the bookkeeping is done by journal entry? The answer is yes.

- › Posting a journal entry at year-end or any other time only takes seconds regardless of the size of the entity. Unusual journal entries can be an indicator of management fraud (CAS 240.A41-A44). Indications of management fraud in any audit moves engagement risk to a whole new level and significantly changes the work effort required to reduce that risk to an acceptable level; in some cases engagements cannot even be completed. It would be very hard for a practitioner to justify missing a material year-end adjustment posted by any client, especially one occurring **right at** year-end.
- › Unusual entries may also be an indicator of poor recordkeeping throughout the year. For example, clients with poor systems for tracking billings and accounts receivable may try to make adjustments at year-end to fix accounts that were incorrect all year long. These significant year-end adjustments may be symptomatic of on-going control deficiencies and may mask possible errors in completeness of revenue or existence of accounts receivable. At

worst, the statements could be materially misstated; at best, the client could benefit from the auditor's advice on how to improve the accounting systems.

Efficiency:

The effort required to review journal entries around the year-end depends on the complexity of the client and its accounting system. For example, for a very small entity, the general ledger for the entire year can usually be reviewed in a matter of minutes. With a focus on areas where material misstatements are likely to occur, such as receivables, inventory or revenue, and where fraud is a possibility, like with cash, significant adjustments should be neither hard nor time consuming to detect. In entities with more complex accounting systems, the work effort will of course be greater. In both cases, however, the person performing the review must be sufficiently experienced and knowledgeable to know what to look for. As testing journal entries is not a one-size-fits-all procedure, you can't expect a junior staff person to pick up on unusual entries if they do not have the experience to know what might be unusual. For maximum efficiency, the review should probably occur at the start of year-end fieldwork. That way, the audit plan can be amended for problems noted on a timely basis.

2. Review of subsequent events

What CASs require:

CASs require an auditor to perform procedures to identify events occurring between the date of the financial statements and the date of the audit report that require adjustment to or disclosure in financial statements being audited (CAS 560.07).

Effectiveness:

The reason for this requirement seems obvious as financial statements can always be affected by events occurring after the year-end. Reviewing subsequent events through the end of audit fieldwork is not difficult as auditors routinely look at documents such as bank statements, deposits and purchases after year-end. Subsequent event procedures can also provide an opportunity to assess the appropriateness of significant estimates made during the audit of year-end balances. What takes more effort is reviewing subsequent events between the end of fieldwork and dating of the audit report. This is especially true when there is a significant lapse of time between those two events.

But how much work is really required? This is where the auditor's professional judgment comes to the fore. For example, if the period between the end of field work and issuance of the report is short, an auditor might consider inquiry sufficient if a low-risk client operates in a stable environment and has a good financial management track record, and the audit fieldwork resulted in no unexpected adjustments. Here the risk of misstatement from subsequent events would likely be judged as *low*. More work would be required if the client was in poor financial shape at year-end, operates in an unstable environment, and the audit resulted in unexpected adjustments. Failure to consider the impact of subsequent events in this situation results in a significant increase in engagement risk.

Efficiency:

Performing a subsequent events review just before completing an audit can seem like a time consuming annoyance since the statements are ready to be finalized, the audit work has been substantially completed, and the engagement team has likely moved on to other clients. But, reframing the issue as a further opportunity for client service might get a different reaction. As effective client communication is a big part of client service, calling and/or visiting the client prior to finalizing a set of statements is a chance to touch base, ask how the year is progressing, and discuss how the audit went from the client's perspective. This action may result in auditors getting two for the price of one: reduced engagement risk and a happy client.

3. Evaluation of design and implementation of internal control – Walkthroughs

What CASs require:

Every audit, regardless of size, requires evaluation of internal control relevant to the audit (CAS 315.12). This is required even if the auditor does not intend to rely on those controls in the response to identified risks of material misstatement (CAS 330.08). As inquiry of an entity's personnel is not deemed sufficient in developing an understanding of *relevant* internal controls (CAS 315.13), many auditors perform and document a so-called walkthrough of one or more transactions related to each *relevant* control. Walkthroughs are an effective and efficient way for an auditor to both understand and document design and implementation of internal controls. Application material to the requirement suggests that inquiry, observation, inspection of documents and "tracing transactions through the information system relevant to financial reporting" may be included (CAS 315.A74).

Effectiveness:

Properly designed and implemented internal controls over financial reporting are essential to produce credible financial information in entities of all sizes. Understanding these controls is an important element in assessing the risks of material misstatement and, regardless of the size of the entity, will affect the design of audit procedures in responding to those risks. Compare, for example, audit procedures addressing existence of accounts receivable in the audit of an entity where there is no systematic review of accounts receivable balances versus one where receivables are analysed monthly. More persuasive evidence will likely be required in the former as risk of material misstatement is greater.

Tracing and documenting each relevant control applicable to a transaction stream from beginning to end (e.g. from sales order to cash receipt) is an effective way for an auditor to corroborate inquiry of client personnel and ensure the understanding of controls is correct. This will aid in designing effective substantive procedures and, as importantly, help to minimize carrying out an ineffective one. So, while transaction walkthroughs of relevant internal controls may not be mandatory, they are generally the most effective way to obtain the required understanding and hence design effective audit procedures.

Efficiency:

In many relatively low-risk audits of small entities, internal controls are not relied on as a source of audit evidence. If an auditor knows that a transactions stream like disbursements will be tested regardless of the outcome of the understanding of controls, use the walkthrough transaction as one of the transactions in the sample. It just makes sense to use the first item tested as the walkthrough transaction as changes required in audit approach resulting from a revised understanding of internal control can be implemented before effort has been wasted. Having said that, the walkthrough must test the design and implementation of controls, so the auditor may need to perform slightly different procedures than those used in a typical substantive test.

4. Fraud risk factors and revenue recognition

What CASs require:

In every audit, there is a presumption that there are risks of material misstatement due to fraud in revenue recognition (CAS 240.26). There is a very clear expectation of what must be done in response to this risk: revenue types, transactions or assertions that give rise to these risks must be evaluated. Even if the auditor concludes there are no such risks, that must be documented (CAS 240.47). Auditors are then required to design procedures to specifically address identified risks at the assertion level (CAS 330.06). And, if an auditor does come across a fraud risk for which no controls are in place, it must be reported to the appropriate level at the client (CAS 265.09).

Effectiveness:

So why is this such a big issue? Many notable frauds have resulted from errors in revenue recognition, including revenue not being recorded in the books. Regardless of size, whenever a fraud is uncovered

after an audit has been completed, questions inevitably arise as to auditor competence. This has potentially damaging effects on the reputation of individual auditors and the profession as a whole. Fraud risk is always a significant factor and needs to be dealt with head on in every audit.

The standards point auditors in a very specific direction: look at revenue types, transactions and assertions in the planning phase of every audit, understand the controls in place at the client to mitigate those risks, and plan the audit response accordingly. The evaluation of risks in the planning phase must be carried out by professionals with appropriate experience if it is to be effective and reduce engagement risk to an appropriate level. The importance of assessing risks of material misstatement from revenue recognition should be emphasized for all staff on the audit team in the planning process, which can only help to increase professional skepticism and focus auditor awareness on this area.

Efficiency:

The work involved in evaluating risks of material misstatement due to fraud in revenue recognition will be proportionate to the complexity of the entity audited. In a small entity with one or two revenue streams, the process will be much less complicated than in a large entity with diverse sources of revenue. Consider rolling the requirements around revenue recognition into the planning phase of every audit. Once they are incorporated into the regular audit program, they will be less likely to be seen as an add-on.

Opportunities to reduce audit risk and increase efficiency

When complying with audit requirements, auditors should look at ways to implement the requirements in both an effective and efficient manner. The focus on reduction in audit risk and increased efficiency on the job should make compliance with all relevant standards a more palatable proposition.

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