TIPS FOR COST-EFFECTIVE ISA APPLICATION

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As attention turns to the clarified International Standards on Auditing (ISAs) issued in 2009,[1] it may be a good time for auditors to assess whether the risk-based approach, which became effective for 2005 audits and underpins these ISAs, is being applied in a cost-effective manner.

The IAASB staff issued a Q&A document, *Applying ISAs Proportionately with the Size and Complexity of an Entity*,[2] in August 2009 to assist auditors in applying the clarified ISAs in a cost-effective manner.

Below are some additional tips that may help:

1. Embrace the ISA requirements.
2. Identify sources of risk, not just the effects.
3. Spend time to plan well.
4. Understand the control environment.
5. Aim for continual improvement.
6. Two-way communication.

TIP 1. EMBRACE THE ISA REQUIREMENTS

"Knowledge is power" Sir Francis Bacon, 1597

It is surprising how many small and medium-sized practices (SMPs) have yet to take the time required to study the ISAs. Incomplete knowledge can be self-defeating as it creates uncertainty about what is really required by the ISAs. The result is wasted time deliberating over what has to be done and performing unnecessary work, just in case it may be needed. In particular, lack of knowledge about requirements may lead to:

- The entire risk assessment phase of the audit becoming an "add on" to the other substantive audit work performed, instead of being used to focus audit effort on areas where there is a greater risk of misstatement in the financial statements.

- Turning what should be a simple audit into a complex and time consuming project. This can arise if efforts are focused on completing needless standard audit forms and checklists rather than using professional judgment to scale the work according to the size and complexity of the entity being audited and the risks involved.

Another important element is attitude. If the engagement partner has a negative attitude then ISA implementation may simply mean extra work just to comply rather than an opportunity to improve the quality and cost effectiveness of the audit. It is better to embrace the ISAs. Gaining a sound knowledge of what is required can be empowering. It equips partners and key staff to lead the way, to use their professional judgment wisely, and to make informed, confident decisions on matters such as:

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[1] See http://web.ifac.org/clarity-center/index

[2] http://web.ifac.org/publications/international-auditing-and-assurance-standards-board/practice-alerts-and-q-as#applying-isas-proportionate

- Changes needed in engagement workflow and the firm's system of quality control, including:
  - Partner involvement in planning.
  - Customizing audit forms and checklists to be scalable for different sizes and complexity of audit clients, particular industries, and particular engagement risks.
  - Ongoing staff communication and file reviews.
  - Engagement productivity.
- Identifying the areas where staff training is required.
- Determining what to include (and what not to include) in audit scope, risk assessment, and designing responsive audit procedures.
- How to address the risk of fraud.
- Efficient allocation of staff and other resources.

An understanding of the ISA requirements is also important for:

- Building the underpinning required to implement future changes to the ISAs.
- Refining the firm's audit approaches to deal with issues arising from implementing the standards on particular engagements. Audits of many small entities may be straightforward, but some can also pose challenges (such as less sophisticated accounting expertise and less formalized internal control) that do not exist in larger entities.

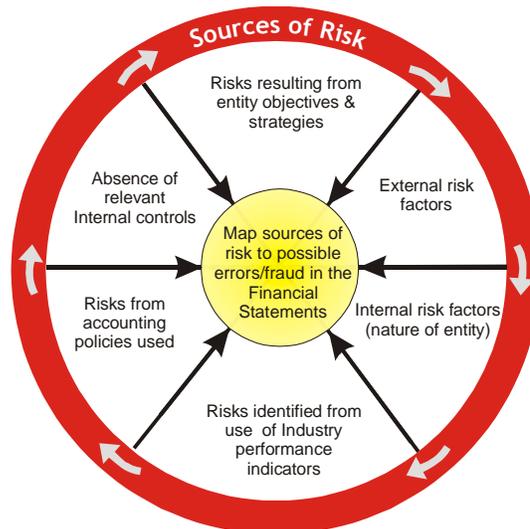## TIP 2. IDENTIFY SOURCES OF RISK, NOT JUST THE EFFECTS

"Learning is the discovery that something is possible" Fritz Perls

When auditors are asked to identify risks, the natural tendency is to start by reading the financial statements. While this may identify the effect of risks that could apply to virtually any entity, such as valuation of inventory, completeness of sales, or accuracy of estimates, such an approach may fail to identify fully the bigger and more pervasive risks that are specific to the entity. These sources of risk could include adverse industry trends or an accountant prone to error, which could affect virtually any account balance.

Rather, start by identifying the sources of risk and then, as the second step, linking those sources to possible effects in the financial statements. For example, a source of risk could be a declining demand for the entity's products. One obvious misstatement (effect) in the financial statements would be valuation of inventory. But it would be a mistake to stop there. Think about other possible misstatements emanating from this source of risk. For example, declining sales could result in a sales manager just missing a bonus threshold, banking covenants could be breached, or a going concern issue may exist. In fact what seems, on the surface, to be a straightforward business risk may also provide someone with the opportunity or incentive to commit fraud—take that sales manager who stands to get a reduced bonus.

ISA 315 is entitled *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*. Therefore, risk identification should come from our understanding of the entity as a whole, not just from reading the financial statements.

One way of thinking about this is to consider the sources of risk, obtained from understanding the entity and its environment, such as those in the chart below.

Sources of Risk

Risks resulting from entity objectives & strategies

Absence of relevant Internal controls

External risk factors

Map sources of risk to possible errors/fraud in the Financial Statements

Risks from accounting policies used

Internal risk factors (nature of entity)

Risks identified from use of Industry performance indicators

* RMM = Risks of material misstatement

As information is obtained about each area, take time to identify possible sources of risk. Then consider what misstatements (including those that might arise due to fraud) could occur in the financial statements as a result. Many of the risk sources identified in this way will likely be pervasive in nature (they cannot be allocated to specific assertions), which will help in assessing risks at the financial statement level.

Effective risk identification also provides information that can used to develop constructive recommendations in areas the entity should consider.

TIP 3. SPEND TIME TO PLAN WELL

"He who fails to plan, plans to fail" Anonymous

It has been said that for every hour spent in planning, five hours can be saved in execution. Many SMPs have found this to be true. Effective audit planning is often the difference between a quality audit within budget and a poor quality audit over budget.

Effective planning requires two key ingredients:

- Undistracted time of the engagement partner and key staff. This does not necessarily mean dedicated team meetings held in the office. On very small engagements, planning can be achieved through brief discussions at the start of the engagement and as the audit progresses.

- Willingness to make key decisions based on appropriate professional judgment.

Planning involves:

- Informing the team on what the entity is all about, what has changed in the past year, and the likely implications of those changes.

- Addressing audit inefficiencies identified in prior year engagements.

- Ensuring staff fully understand what they are required to do and why.

Key questions that should be discussed at the planning session include those in the chart below.
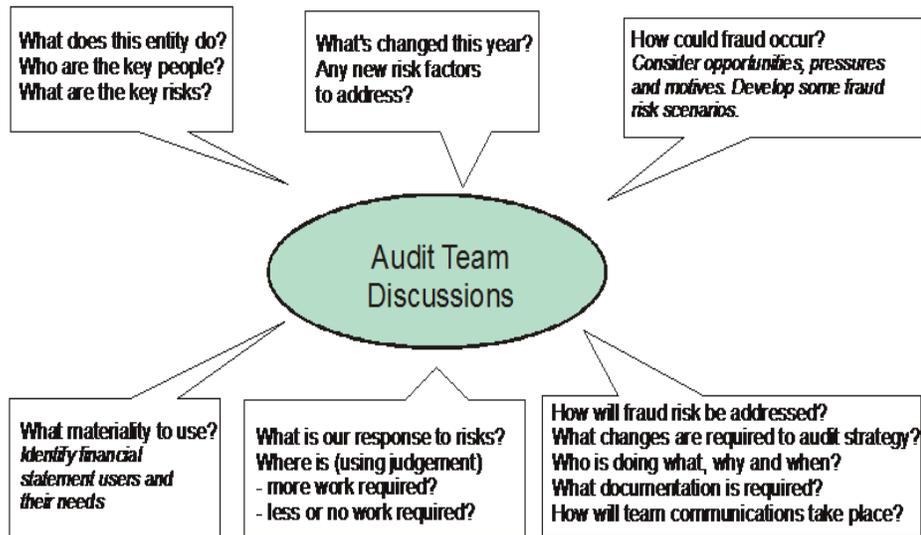
In addition, encourage staff to identify areas where audit procedures seem excessive in relation to the risk of misstatement being addressed. For example, if a number of account balances are immaterial, is it necessary to perform a long list of standard audit procedures that might be more applicable to a much larger balance?

Take time to ensure each staff member understands the necessity and purpose of the documentation they are required to complete. Countless hours can be lost by staff attempting to complete a form they do not understand.

Other planning tips include:

- Ensure that fraud risk is properly addressed. Because fraud is deliberate, detecting it may require some element of unpredictability, such as performing certain audit procedures on a surprise basis. Encourage staff to be skeptical and inquisitive and empower them to raise issues, observations, or unexplained matters. Fraud may be discovered through piecing together a number of small matters that by themselves would seem insignificant.

- Consider assigning similar or related file sections to the same staff member. This will ensure work performed in one area is not repeated again in another.

TIP 4. UNDERSTAND THE CONTROL ENVIRONMENT

When obtaining an understanding of internal control relevant to the audit, see that controls, such as those found in the control environment, are identified. One may wish to refer to such controls as "pervasive controls." Pervasive controls, which are quite different from transactional controls, address matters such as integrity and ethics, corporate governance, employee competence, managements' attitudes toward control, fraud prevention, risk management, and control monitoring. The chart below illustrates one way of viewing pervasive and transactional controls.
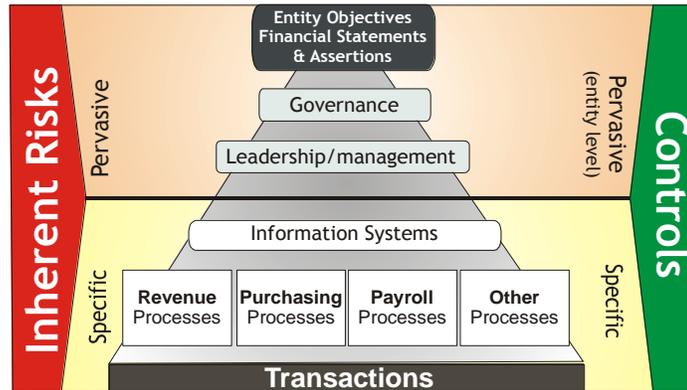
The most important controls in entities of any size are those found in the control environment. This is sometimes referred to as the "tone at the top," which outlines the values of the entity and management's commitment to competency and ethics. If the tone at the top is good, the owner-manager of a small entity may exercise effective control over transactions which otherwise might be done through extensive segregation of duties in a larger entity. However, if the tone at the top is poor, management override can easily occur and even the very best transactional controls over processes, such as purchases and sales, could be overridden.

One can see that under the risk-based approach, only relevant controls are identified, documented, and assessed.

TIP 5. AIM FOR CONTINUAL IMPROVEMENT

There is a tendency for some auditors to blindly follow the example of the previous auditor, resulting in a file that mirrors that of last year. A better approach would be to document once (in the first year) and then update the existing documentation (to the extent possible) for changes in subsequent years. The documentation in year one should enable auditors in subsequent years to leverage their understanding of the entity and focus attention on new industry trends, key operational changes, new inherent risks, and revised internal controls. If changes are minimal, then so too will be the additional documentation.

Achieving continual improvement requires consideration of existing practices at all planning meetings. Here are a few suggestions:

- **Revise the file index.**

    The ISAs have introduced new terminology and concepts that are central to the audit. Review your firm's file index to incorporate the new terminology and processes.

- **Consider how file information can best be reviewed—this year and in future years.**

    o *Document all risks identified, and their assessment, in one place.* Recording risks in one place reduces the chance of missing some, helps ensure risks get assessed in a consistent manner, and makes the file easier to review. One can also include cross reference risks to the risk response. Finally, it also makes the task of updating risk factors, later in the audit and in subsequent years, easier.

    o *Standardize how internal controls will be documented.* When documenting internal controls, ensure that the linkage between the risks of material misstatement and the control procedures to mitigate such risks is clear. This

enables the file reviewer to assess control design, and when changes take place, the impact on control design can easily be identified.

o *Record audit issues, their resolution, and any related communications to management or those charged with governance in one place.* This might take the form of a summary memorandum. This will ensure key issues are not missed in the file review process and will assist in planning the audit in subsequent years.

TIP 6. TWO-WAY COMMUNCATION

Good ongoing communication (while maintaining the auditor's independence and objectivity) between the auditor, management, and those charged with governance is important to avoid misunderstandings and to develop constructive working relationships. Consider, for example, explaining to management (and those charged with governance) what an audit is all about, the responsibility of the auditor under the ISAs, and what management can do to help the audit go smoothly.

SUMMARY

1. Take time to study the ISAs. Embrace them.

2. Identify the sources of risk specific to the entity, and then identify the effects on the financial statements.

3. Time spent in planning will save hours in execution. Use professional judgment to focus audit effort where it is needed most.

4. Understand the control environment.

5. Aim for continual improvement in the audit. This includes documenting audit evidence in year one so that it can be easily updated in subsequent years, as well as considering each year how audit efficiency can be improved.

6. Ensure management is fully informed as to what an audit is all about and establish clear and constructive channels of communication that will help the audit run smoothly.

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IFAC RESOURCES

Online

- *International Center for Small and Medium Practices* at www.ifac.org/smp which includes:
    o Relevant links at http://www.ifac.org/SMP/relevant_links.php
    o Free quarterly e-newsletter at http://www.ifac.org/SMP/index.php#News
- *IAASB Clarity Center* at http://web.ifac.org/clarity-center/index

Publications

- All IAASB and SMP Committee publications can be found under the Publications & Resources Section of the IFAC website at http://web.ifac.org/publications.

- *Applying ISAs Proportionately with the Size and Complexity of an Entity* is at http://web.ifac.org/publications/international-auditing-and-assurance-standards-board/practice-alerts-and-q-as#applying-isas-proportionate.

- *ISA Modules* developed by IAASB staff are at http://web.ifac.org/clarity-center/support-and-guidance#support-modules.

- *Guide to Using International Standards on Auditing in the Audit of Small- and Medium-sized Entities* is at http://web.ifac.org/publications/small-and-medium-practices-committee. Some IFAC member bodies have adapted this for their own members, such as the Institute of Chartered Accountants in Australia (ICAA) (see http://www.charteredaccountants.com.au/A121542159) and the Malaysian Institute of Accountants (MIA) (see http://www.mia.org.my/new/psp_auditandassurance_knowledgebase_the.asp). An updated Guide, conforming to the clarified ISAs, is planned for mid-2010.

- *Guide to Quality Control for Small- and Medium-Sized Practices* is at http://web.ifac.org/publications/small-and-medium-practices-committee. An updated Guide is planned for mid-2010.

- Translations of some of the above publications are at http://www.ifac.org/Translations/database.php.