

Circulate to:	✓
1.	
2.	
3.	
4.	
5.	
6.	
7.	
8.	
9.	
10.	

Focus on PEM

Published three times a year to help CAs keep current on professional engagement matters

Inside

VOLUME 2, ISSUE 1
APRIL 2007

- 1 FREQUENTLY ASKED QUESTIONS
Audit Risk for Small Entities
 - Where do we start?
 - What are the key steps involved in the process?
 - How do we use the risk control matrices in PEM?
- 10 Evaluating Internal Controls
- 13 Combined Risk
- 15 Performing Procedures, Evaluating Results and Forming an Opinion
- 16 Moving Forward

Frequently Asked Questions

Audit Risk for Small Entities

This special edition of *Focus on PEM* addresses the four most frequently asked questions on the application of the new audit risk standards:

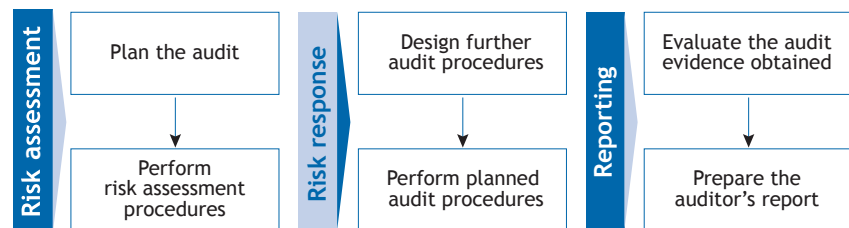
- Where do we start?
- What are the key steps involved in the process?
- How do we use the risk control matrices in PEM?
- How can we make the process cost effective for very small audit engagements?

The first three questions are answered in the sections that follow. The fourth question is answered by way of an illustrative case study that is discussed throughout this article.

Where do we start?

For many small and medium-sized firms, the risk based audit approach will result in additional time being spent (often by senior staff) in risk assessment, planning and documentation. However, some of this extra time may be saved in performing detailed testing, if the planned audit procedures are linked and respond appropriately to the risk assessment.

The key steps in the audit process are as follows:



New Audit Process

There are certain realities that stem from this new audit process:

- The *CICA Handbook – Assurance* does not distinguish between the audit approach required for a two-person entity from that required for an entity with 50,000 people. An audit is an audit is an audit. It is the nature, timing and extent of audit procedures required that will be quite different.

- Risk identification/assessment and designing a risk response require careful thought and talking to key employees other than the owner. These procedures require professional judgment and the ability to ask meaningful and open-ended questions. This process cannot be reduced to a “check the box” form that may be completed with minimal thought.
- Consideration of fraud (particularly management override) has been a requirement of the *CICA Handbook – Assurance* since 2002. We should be stressing the need for professional skepticism in all of our audit work, identifying fraud risk and thinking carefully about what is not (but should be) in the financial statements.
- Additional documentation will be required throughout the audit process. This includes the documenting of linkages between the auditor’s risk assessment and the design of further audit procedures, such as the nature, time and extent of substantive procedures. The audit approach in the PEM has been designed to help auditors document the risk assessment process and design appropriate linkages to the detailed audit procedures.
- For most firms, the new audit approach will require some additional (ongoing) engagement time to complete. In the first year of change, there will be an investment required to:
 - Train partners and staff on the new approach;
 - Gather additional information (including a broader understanding of internal control) for the risk assessment;
 - Document linkages between risk assessment and the design of further audit procedures; and
 - Become familiar with the new PEM forms.

Summary of the CICA Handbook - Assurance Requirements Relating to the Risk Assessment Phase of the Audit

Handbook References	Comments
<p>Overall Audit Strategy 5150.08 The auditor should establish the overall audit strategy for the audit.</p>	<p>Sets the scope, timing and approach and guides development of more detailed audit plan.</p>
<p>Use of Assertions 5300.20 The auditor should use assertions for classes of transactions, account balances and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.</p>	<p>The <i>CICA Handbook - Assurance</i> outlines 13 assertions. PEM continues to summarize these assertions as Completeness, Existence, Accuracy (including cut-off) and Valuation</p>
<p>Understanding the Entity 5141.002 The auditor should obtain an understanding of the entity and its environment including its internal control sufficient to <i>identify and assess</i> the risks of material misstatement of the financial statements whether due to fraud or error and sufficient to design and perform further audit procedures. Key aspects of this understanding (other than internal control — see below) include: .022 Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework. .025 The nature of the entity. .028 Entity’s selection and application of accounting policies. .030 Entity’s objectives and strategies, and the related business risks. .035 Measurement and review of the entity’s financial performance.</p>	<p>Risk assessment procedures are used to:</p> <ul style="list-style-type: none"> • Identify risks; • Relate identified risks to what can go wrong at the assertion level; and • Consider the significance and likelihood of the risks.
<p>Understanding Internal Control 5141.041 The auditor should obtain an understanding of internal control relevant to the audit. This includes the five internal control components below: .067 The control environment. .076 Process for identifying business risks relevant to financial reporting. .081 The information systems, including the related business processes. .090 Control activities to assess RMM at the assertion level. .096 Major types of activities used to monitor internal control over financial reporting. 048 It is a matter of the auditor’s professional judgment, subject to the requirements of this Section, whether a control, individually or in combination with others, is relevant to the auditor’s considerations in assessing the risks of material misstatement and designing and performing further procedures in response to assessed risks. In exercising that judgment, the auditor considers the circumstances, the applicable component and factors such as:</p>	<p>Risk assessment procedures are used to evaluate whether:</p> <ul style="list-style-type: none"> • Internal controls, individually or in combination with other controls, are capable of effectively preventing, or detecting and correcting, material misstatements (design); and, • Internal controls exist and that entity is using them (implementation).

Handbook References	Comments
<p>Understanding Internal Control (continued)</p> <ul style="list-style-type: none"> (a) the auditor’s judgment about materiality; (b) the size of the entity; (c) the nature of the entity’s business, including its organization and ownership characteristics; (d) the diversity and complexity of the entity’s operations; (e) applicable legal and regulatory requirements; and (f) the nature and complexity of the systems that are part of the entity’s internal control, including the use of service organizations. <p>.054 Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented.</p> <p>.055 <i>Enquiry alone</i> is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.</p>	
<p>Identify and Assess Risks</p> <p>5141.101 The auditor should identify and assess the risks of material misstatement at the F/S level and at the assertion level for classes of transactions, account balances and disclosures.</p>	<p>Separate or combined assessments of inherent and control risk may be made.</p>
<p>Significant Risks</p> <p>5141.109 As part of the risk assessment as described in 5141.101, the auditor should determine which of the risks identified are, in the auditor’s judgment, risks that require special audit consideration. In paragraph 5135.060, revenue recognition is presumed to be a significant risk.</p>	<p>Significant risks, which arise on most audits, are a matter for the auditor’s professional judgment.</p>
<p>Documentation</p> <p>5141.123 The auditor should document:</p> <ul style="list-style-type: none"> (a) The discussion among the engagement team regarding the susceptibility of the F/S to material misstatement due to error or fraud, and the significant decisions reached; (b) Key elements of the understanding obtained (see above), the sources of information from which the understanding was obtained, and the risk assessment procedures; (c) The identified and assessed risks of material misstatement at the F/S level and at the assertion level as required by paragraph 5141.101; and (d) The risks identified and related controls evaluated as a result of the requirements in paragraphs 5141.114 and 5141.116 (significant risks). 	<p>Document the procedures performed, evidence obtained and conclusions reached with respect to relevant F/S assertions.</p> <p>Audit documentation should clearly demonstrate that the work was in fact performed.</p>
<p>Communication</p> <p>5141.121 As soon as practicable, the auditor should make the audit committee or equivalent aware of material weaknesses in the design or implementation of internal control that have come to the auditor’s attention.</p> <p>5220.08 The auditor’s responsibility to communicate significant weaknesses in internal control applies equally to the audit of owner-managed and smaller entities.</p>	<p>The timing of when to communicate is guided by the significance of the specific matter and an assessment of its urgency.</p>



New PEM Audit Forms

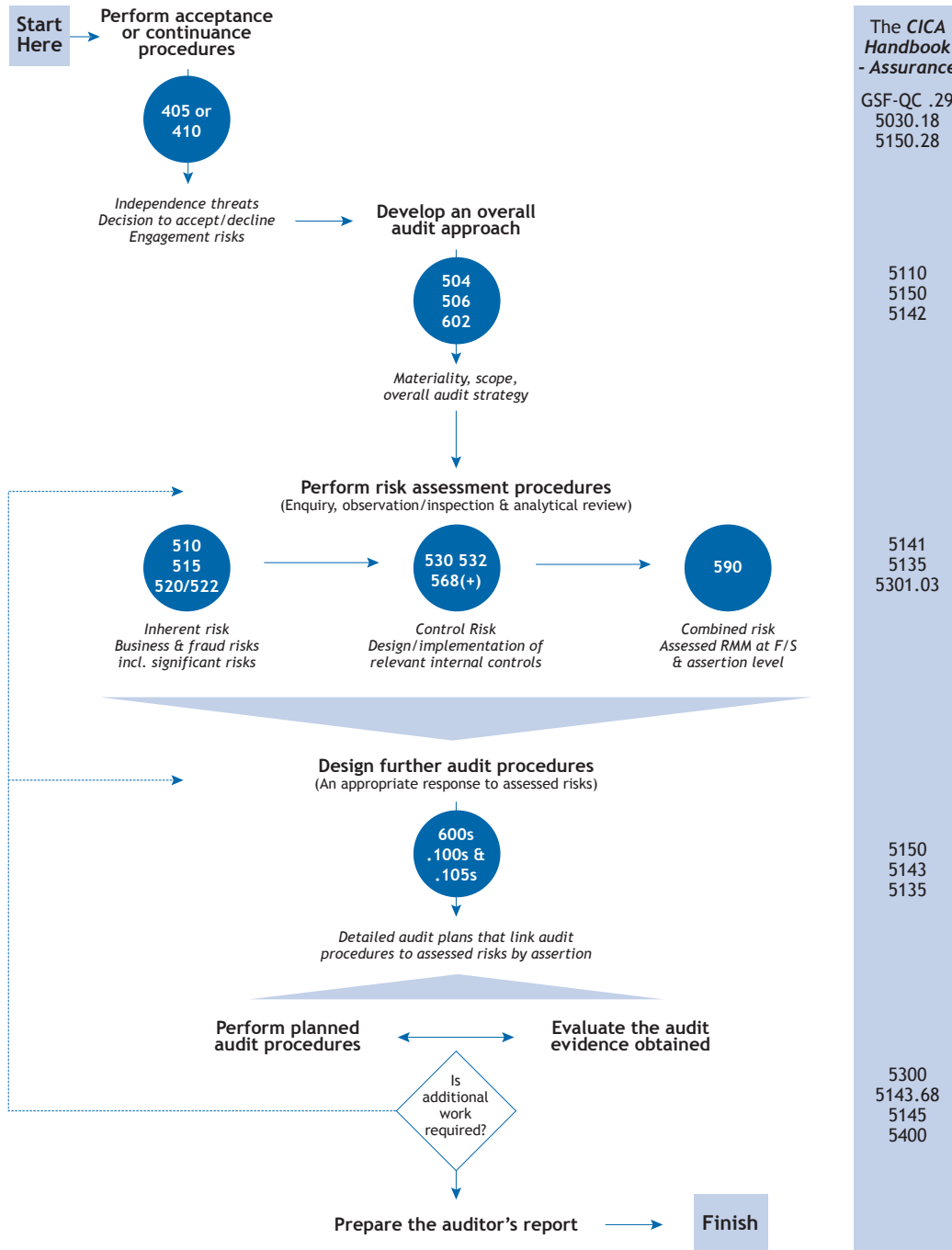
The character and use of the PEM audit forms have also changed. Instead of the standard yes/no type of checklist, many of the risk assessment forms in PEM are designed to serve as a database for recording and assessing key information. The goals are to meet the *CICA Handbook – Assurance* requirements, facilitate ease of preparation of the audit and file review, and enable their use (after review for changes) in many subsequent years. It is highly recommended that these (non-checklist) forms be completed using Word and Excel. This allows for the flexibility, tailoring of input and sorting of results required.

Note: The PEM forms entitled “Worksheet” are not mandatory. These worksheet forms should be used where applicable or as a guide to documentation requirements.

What are the key steps involved in the process?

The PEM audit process is illustrated in the following chart. Note the key forms that would be completed on most audit engagements.

Steps Involved in the PEM Audit Process



● = Key PEM Forms

The following table provides additional detail on the steps involved.

Detailed Audit Steps

Task	Methodology	Deliverable	Key PEM Forms
1. Perform acceptance or continuance procedures	Answer questions such as <ul style="list-style-type: none"> • Are we independent? • Is there client integrity and competence? • Can the client pay for our services? 	A decision whether or not to proceed with engagement?	405 or 410 & QAM risk assessment forms
2. Develop an overall audit approach	Review results from previous year, identify any major changes and establish/reconfirm the scope, materiality, timing, who will be assigned and the basic audit approach.	Start of the overall audit plan and strategy	602, 504, 506
3. Perform risk assessment procedures	Use risk assessment procedures to: <ul style="list-style-type: none"> • Identify and then assess business and fraud risks that result from the required aspects of understanding. • Identify significant risks. • Evaluate the design and implementation of controls that mitigate risks of material misstatement. Address each of the five components of internal control. Summarize results of procedures on Form 590.	<ul style="list-style-type: none"> • Listing of assessed risks at the F/S & assertion levels • Listing of significant risks • Control documentation • System walk-throughs • Assessment of control design/implementation • Communication of material weaknesses in internal control with management and audit committee 	510 515 (or 520/522) 530, 532 568-580 as applicable and 590
4. Design further audit procedures	Finalize the overall audit strategy based on the assessment of risk at the F/S level. Develop an appropriate audit response (by F/S area and assertion) to the assessed risks identified.	<ul style="list-style-type: none"> • Overall audit strategy • Detailed audit strategy by F/S area and assertion 	600 series of Forms .100 and .105 Forms for applicable F/S areas
5. Perform planned audit procedures	Perform the planned procedures outlined in the overall and detailed audit plans.	<ul style="list-style-type: none"> • Audit evidence 	
6. Evaluate the audit evidence obtained	Stop and consider : <ul style="list-style-type: none"> • The completeness of evidence obtained; • Impact of new risks identified; • Inability to complete any audit tests; • Any disagreements with management; • Misstatements identified; and, • Any warning signals of possible fraud. Then take the appropriate responsive action.	<ul style="list-style-type: none"> • Revisions to assessed risks • Changes to planned audit procedures • Results of additional work performed • Communications with management 	310- completion checklist
7. Prepare the auditor's report	Consider the audit findings and evidence obtained and prepare/issue an appropriate auditor's report	<ul style="list-style-type: none"> • Auditor's report 	

For many firms, the most significant changes in the audit approach will relate to the performance of risk assessment procedures. The purpose of and documentation resulting from performing these procedures are discussed below.

To illustrate the thought processes required and the use of the relevant PEM forms, we have used a case study called SPEC, which is based on a very small not-for-profit entity.

CASE STUDY

SPEC (Special Persons Education Clinics) has an Executive Director and a part-time bookkeeper. SPEC was hired to organize and administer a number of special education clinics for disadvantaged children in Northern British Columbia. Primary funding is in the form of a government grant (\$350,000) plus some contributions from parents and other donors (\$60,000). Expenditures include payroll (\$85,000), program costs (\$310,000), and out-of-pocket traveling costs (\$15,000). There is a five member board consisting primarily of teachers and parents of children who are in the program. There is little financial expertise at the board or operating level.

The auditor is Howard James. Howard struggled at first as to whether he should be the auditor at all. In performing his client acceptance procedures, he noted that the lack of financial expertise posed an independence threat of self-review. He wondered whether he should just help the organization in preparing their financial statements and be an advisor. However, when a retired CA in town agreed to help prepare the year-end financials, he accepted the audit engagement.

After being appointed auditor, Howard prepared an overall audit plan and provided the board of directors with a written summary which he sent out with the independence letter.

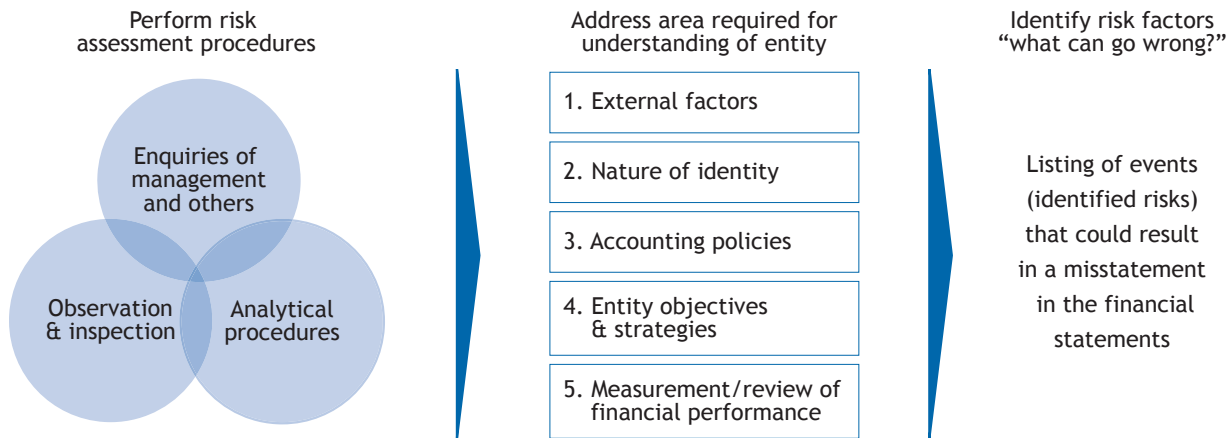
Performing Risk Assessment Procedures

Risk assessment procedures involve two major steps that are used to assist us in understanding the entity:

- Identifying and assessing inherent risks
- Evaluating whether internal controls exist to mitigate the risks of material misstatement.

Step 1: Identifying and assessing inherent risks

This step involves the use of risk assessment procedures to identify and then assess potential risks of material misstatement in the financial statements, as illustrated in the chart below.



PEM Form 510 addresses each of the five aspects of understanding. This Form enables the auditor to record a lot of basic information about the entity. For each question, the Form also asks (with some points for consideration provided to facilitate the assessment) whether the findings represent a potential source of risk to the entity. Because this Form only serves to identify risks, not to assess them, each risk factor identified on 510 should then be recorded on the appropriate (business or fraud) risk register (Form 515 or Forms 520 and 522). Other risk factors may also be identified from performing other risk assessment procedures.

Note: The ranking of 1-5 on Form 510 is simply to identify the risks that should be recorded for subsequent assessment on the risk register.

Risk Register

The risk register is where we document all the risks identified from the five aspects of understanding the entity (see the chart above) plus any other risks that we may identify during any other phase of the audit. The risk register should be the core form for documenting identified risks and then assessing them. Assuming the risk assessment is made numerically (i.e., 1-4), the risk factors can then be sorted (using Excel) with the highest assessed risks at the top of the page.

Note: The only risks that do not (initially) get recorded on the risk register are transactional risks that exist at the business process level (such as goods being shipped but not invoiced). These transactional risks will be addressed when we evaluate internal control for a particular business process. If, however, there were no mitigating controls identified for a significant transactional risk, details should then be recorded on the risk register, the risk appropriately assessed and an audit response developed.

The risk register can also be used to organize and document the discussions among the engagement team and the entity regarding:

- The susceptibility of the F/S to material misstatement due to error or fraud;
- Significant decisions reached; and
- Details of the audit plan, including who does what, etc.

CASE STUDY

In the case of SPEC, the business and fraud risk registers might include the following:

Risk register

515

Use this worksheet to document and assess risk factors (identified at any stage in the audit process), their implications and planned audit response. As a guide, risk factors with a risk assessment (Likelihood x Impact) score of 12 or more should be considered as 'significant' audit risks. Discuss this worksheet (risk register) with management to ensure completeness and the appropriateness of the risk assessment.

Entity SPEC Period ended December 31, 20XX
 Materiality overall \$6000

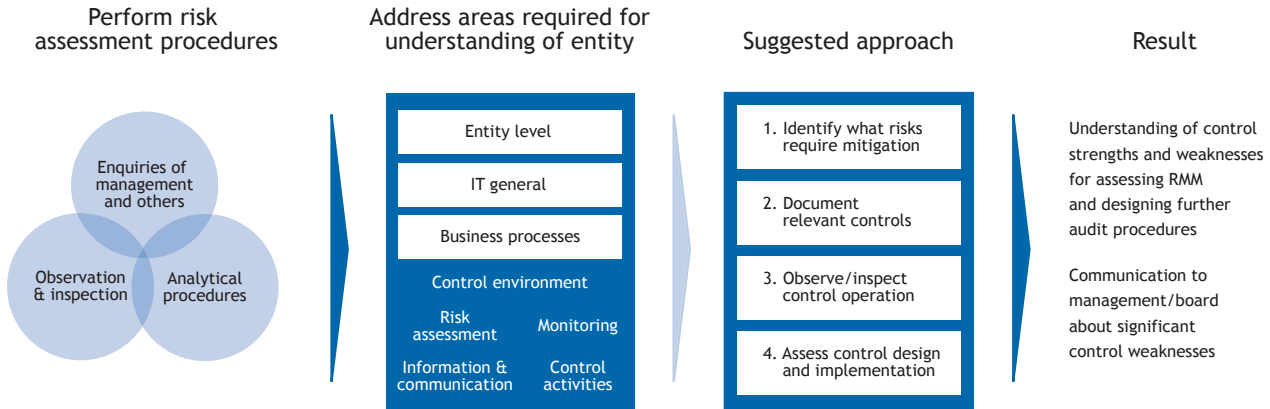
Risks identified	What could go wrong as a result?	FSA impact – CEAV			Risk assessment		Signif't risk?	Mgmt response W/P	Audit Response (audit plan) W/P	
		Assets	Liab's	Inc	Likeli'd to occur	5 Impact				
BUSINESS RISKS										
No financial expertise on the board	Misstatements in F/S could be missed	all	all	all	4	4	Y			
Terms of funding agreement are not followed	Program disbursements would become repayable to government		C	E	3	3	N			
Annual funding application not made or not filed on a timely basis	Inability to continue operations	all	all	all	2	4	N			
Current government has openly questioned value of this program	Funding could be terminated or reduced resulting in inability to continue	all	all	all	2	4	N			
Executive Director is reaching retirement age	The ED is highly competent. Replacement would be difficult	all	all	all	2	4	N			
FRAUD RISKS										
Funds misspent for personal use by ED or bookkeeper	Misstated F/S	all	all	all	3	4	Y			
Donor receipts not properly recorded	Misstated F/S	E		C	2	3	N			
Expenditures over budget concealed	F/S manipulation	all	all	all	2	3	N			
False suppliers	Misstated F/S		EC		2	2	N			

Notes:

1. The “what can go wrong as a result?” column is often the most difficult to complete. This is because we are trying to identify the types of potential misstatement that could occur in the financial statements. This column records the “so what” of the risks identified.
2. Remember that this risk assessment is at the inherent risk level. This means we ignore factors such as the competence of management and any control systems in place to mitigate such risks.
3. In the list above, there are two significant risks – lack of financial expertise on the board and the potential for funds to be misappropriated. These points should be included in a management letter with some practical recommendations for action.
4. The management response and audit plan columns can only be completed after obtaining the understanding of internal control.

Step 2: Evaluating whether internal controls exist to mitigate risks of material misstatement

This step involves using risk assessment procedures to identify and evaluate internal controls that mitigate the risks of material misstatements, as illustrated in the chart below.



Before describing the suggested four-step approach outlined in the diagram, let's first review the benefit of using the risk control matrix in this process.

How do we use the risk control matrices in PEM?

The risk control matrix is an effective means of evaluating the design and implementation of internal control at the business process level and for ensuring each internal control component has been appropriately addressed.

Previous versions of PEM contained internal control evaluation guides. These guides contained a number of internal control objectives and a listing of typical control procedures. This approach to control evaluation was called "one-to-many". This is because 'one' control objective or risk is linked to 'many' controls, as illustrated in the chart below.

One-to-Many Approach

Risk/control objective	Assertion	Mitigating controls	IC component
Risk A	C	Controls in place	(by control)
Risk B	E A	Controls in place	(by control)
Risk C	A	Controls in place	(by control)
Risk D, etc.	C A	Controls in place	(by control)

IC = Internal control
 Assertions: C = Completeness, E = Existence, A = Accuracy

Although this approach is perfectly acceptable, there are a number of significant disadvantages, such as:

- The "one-to-many" approach does not readily identify the many-to-many relationships that exist between risks and controls.
- It results in repetition of controls. This makes it hard to cross-reference any extra information needed about controls.
- It does not readily provide a single list of control procedures for a process.
- Controls that relate to more than one risk factor can be hard to find.

Many-to-Many Matrix

An alternative approach in common use today is what is often referred to as a "many-to-many" matrix. This risk/control matrix links and shows the relationship between "many" control objectives/risks and "many" control procedures. In such a matrix, controls are described only once, making it easier to cross-reference to additional or supporting information. But most important, the matrix enables the auditor to see at a glance the existence of both control strengths and control weaknesses.

Many-to-Many : A Simple Risk Control Matrix

Process xyz					
		Risk A	Risk B	Risk C	Risk D
Assertion		C	E A	A	C A
Control	IC Com				
Control Procedure 1	CA	P			P
Control Procedure 2	IC		D		
Control Procedure 3	CA	P	P		P
Control Procedure 4	M	D			
Control Procedure 5	CA		P		
Control Procedure 6	IC				D
Control Procedure 7	IC	D	D		

C = Completeness, E = Existence, and A = Accuracy

CA = Control Activity, IC = Information and Communication, M = Monitoring

Note the following information that is contained in this matrix:

- The assertions addressed by the risk factors.
- The internal control component (control activity, monitoring, etc.) addressed by the control procedure.
- Where the control procedure addresses (intersects) with a risk on the matrix, a control that prevents a misstatement occurring is recorded as "P" (prevent) and a control that detects a misstatement after it has occurred is recorded as "D" (detect).

The matrix is used as follows:

- **Control Weaknesses**
Look at each risk "column" to see what control procedures exist to mitigate it. Where there are no control procedures identified to mitigate a risk, a significant control deficiency exists. Risk C in the example above appears to be a control weakness.
- **Control Strengths**
Look at the control procedure "rows" to identify control procedures that would prevent or detect a number of misstatements from occurring or effectively address certain assertions. Procedure 3 in the example above would appear to be a key control as it addresses three risk factors and the completeness, existence and accuracy assertions. Such a control, if considered reliable, could be considered for testing its operational effectiveness.

Evaluating Internal Controls

The suggested approach to evaluating internal controls has four steps as follows:

Step 1: Identify which risks require mitigation

The suggested approach is to first identify which risks need to be mitigated. Entity level and IT general control risks may have already been identified on the risk register.

For business process risks (i.e., receipts, disbursements and payroll), the suggested transactional risks (the “what can go wrong risk factors”) on the relevant risk control matrix can be used as a starting point. Eliminate risks that could result in a material misstatement if not mitigated, and customize the wording of other risks to the particular client.

Finally, consider the existence of any other transactional risks that could result in a material misstatement if not mitigated. This step provides the auditor with the context necessary to determine what internal controls are relevant to the audit.

Step 2: Document relevant controls

We do not have to identify and document *all* internal controls. The requirement is to use professional judgment to identify and document *relevant* internal controls. This refers to controls that individually, or in combination with others, mitigate a risk of a material misstatement in the F/S (such as the risks identified in Step 1 above).

First, document the entity and IT general levels. These controls are often pervasive in nature and weaknesses will likely affect the operation of the business process controls. PEM Forms 530 and 532 can be used to document entity level and IT general controls.

Because entity level and IT general controls are often subjective (such as management philosophy), the question and answer approach is often the best. Documenting these controls can easily be combined with Step 3 of the 4 step approach (see below) by inspecting evidence that the controls have been implemented and asking whether there were exceptions during the year. Feedback from auditors indicates that clients often appreciate learning about these types of control weaknesses.

CASE STUDY

For SPEC, the important entity level controls would be the competence of the Executive Director and the annual budget preparation process. Because the Executive Director will be involved in virtually all entity activities, it is unlikely he would miss any important operational matters.

The key weaknesses at the entity level would be:

- **The possibility of management override.**
This could be addressed through establishing anti-fraud policies and performing specific audit procedures.
- **Lack of financial expertise on the board or at the operating level.**
This has been addressed (at least in part) by the hiring of the retired CA to produce the financial statements.

For business processes, the extent of documentation required for relevant controls is a matter for professional judgment. It will vary depending on the size, nature and complexity of the entity. The key requirement is to show the flow of transactions in sufficient detail to identify the points at which material misstatements due to error or fraud could occur. When sufficient controls have been identified to mitigate a risk, there is no need to continue working to find/document other controls that address the same risk.

Step 3: Observe/inspect control operation

The *CICA Handbook – Assurance* states that enquiry alone is not sufficient to evaluate either the design of a control or to determine whether it has been implemented. Consequently, to ensure our risk assessment is valid, it is important that documented (designed) controls are actually in effect. Because processes change over time and in response to new events, this step is required each year.

The recommended approach is to conduct a walk-through. In a walk-through, the auditor traces a transaction from each major class of transactions from origination, through the entity's accounting and information systems and financial report preparation processes, to it being reported in the financial statements. It includes enquiries of personnel, observing the application of specific controls and inspecting documents and reports.

Note: The scope of the walk-through may be confined to controls that individually, or in combination with others, mitigate the risks of material misstatement already identified in Step 1 of the four-step process.

The walk-through addresses control implementation at a point in time. It is not a test of operating effectiveness where the auditor gathers evidence about control operation over a period of time such as a year.

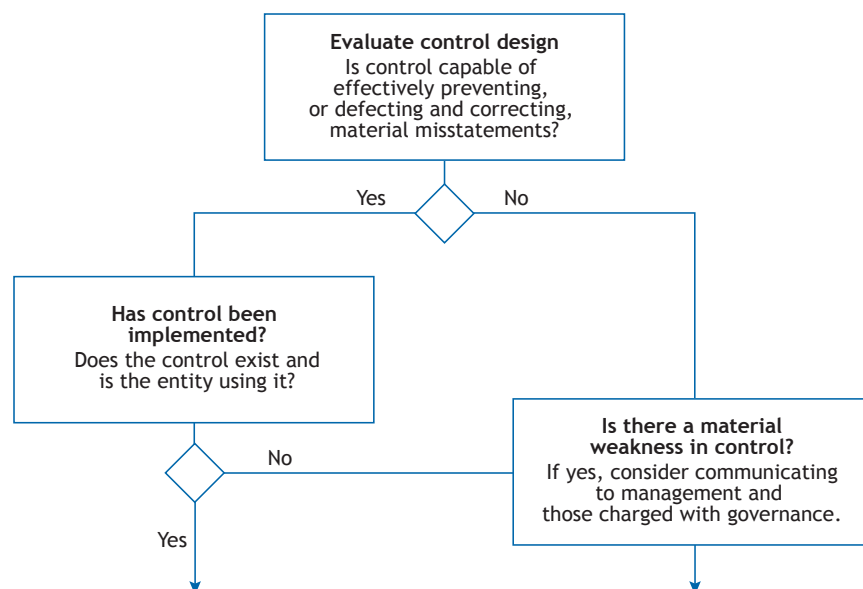
The difference between control design, control implementation and tests of control can be summarized as follows:

- **Control design**
What controls have been designed to mitigate the identified risks of material misstatement?
- **Control implementation**
Are the designed controls actually in operation?
- **Tests of control**
Did the controls operate effectively over a specified period of time?

Step 4: Assess control design and implementation

The final step is to bring all the information obtained together and identify both control strengths and control weaknesses. This step is summarized in the chart below.

Evaluating Control Design and Implementation



For entity level and IT general controls, this assessment will be achieved by reviewing the documentation and the results of the walk-throughs, and then considering whether a material weakness exists.

CASE STUDY

Because SPEC is a small entity, the order of the four-step approach outlined above would be changed.

Step 1 remains the same.

Step 2 would start with documenting the entity and IT general controls in the way described. However, for the business processes, the risk control matrix could be completed as follows:

- Starting with the first risk factor on the risk control matrix, ask the client what controls exist in the entity to mitigate that particular risk. Then record the control procedures identified directly onto the matrix (in the client’s words) and indicate whether they are prevent or detect controls with a “P” or a “D”.
- Then repeat the first step for each of the risk factors. Note that some controls may well prevent or detect a number of the risk factors.

This is an efficient way to document relevant control procedures and it will immediately alert the client to risk factors that have not been mitigated. Then complete Steps 3 and 4 of the suggested approach by documenting the identified controls and conducting a walk-through to ensure identified controls are in existence and have been implemented.

The entire risk control matrix for SPEC’s revenue and receipts process could be documented as illustrated below.

Risk/control matrix – Revenues, receivables, receipts

568

Entity SPEC Date December 31, 20xx

Assertions C = Completeness E = Existence A = Accuracy V = Valuation	Internal control (IC) component CE = Control environment CA = Control activities I&C = Information and communication MO = Monitoring	Transaction frequency C = Continuous W = Weekly M = Monthly Q = Quarterly A = Annual NR = Non-routine	Type of control P = Prevent D = Detect	Internal control component	Control frequency C W M Q A NR	Manual (M) or automated (A)	Control reliability score: 1-3 (1= low)	Risk factors: what can go wrong											
								Receipts are partially or not deposited/recorded	Recorded receipts are credited to the wrong donor (fraud)	Deposits not recorded in accounting records	Mistakes made on donor receipts	Receipts are recorded in wrong period	Funding application not submitted on time	Control tested (Y/N)	W/P ref.				
	Assertion addressed by risk factor							CAE	CAE	A	A	CAE	CAE						
1	A budget is prepared each year that is approved by the board showing the timing of funding application and the expected dates of government and regular donor receipts	CE	A	M	3			D	D	D		D	D						
2	Budget is compared to actual each month in a report to the board	MO	M	M	3			D	D	D		D							
3	Bank reconciliation is prepared by the bookkeeper each month and signed by the ED for approval	CA	M	M	3					D		D							
4	ED compares cheques received from government to the amounts requested in the funding agreement. Discrepancies are followed up.	CA	A	M	3				D										
5	Donor is sent a receipt for each contribution. The number of receipt is noted in the accounting records for each non-government receipt.	CA	C	M	2			D	D			D							
6																			

- Notes:
- The risks and control procedures have been customized to the specific client.
 - There are no preventative controls identified. This is common for very small entities.
 - The budget process is likely the most significant control.
 - All identified risk factors are subject to controls and they appear to be adequately designed.
 - There are no material weaknesses in control over revenues that should be reported to management.

Combined Risk

The final step in the risk assessment phase is to summarize the assessed risks at the F/S and assertion level.

This is carried out by carefully reviewing the risk register, control strengths/weaknesses identified on the risk control matrices and from documentation of entity and IT general controls.

CASE STUDY

For SPEC, Form 590 could be completed (in part) as illustrated below.

Worksheet – Combined risk assessment

590

Entity SPEC

Period ended December 31, 20XX

Use this form to record your assessment of the risk of material misstatement at the overall and assertion levels. The assessments should be carried forward and recorded on the detailed audit plans.			
	High, moderate, low (H, M, L)	Reasons. (identify key risks and other contributing factors)	Audit plan W/P ref.
RMM at the financial statement level	<u>M</u>	Good attitude toward control and competent staff. Minimal segregation of duties. Management override a possibility.	
RMM at the assertion level PSA or F/S Disclosure			
1. Revenue	C = M	No preventative controls. Also Fraud risk.	
	E = M	No preventative controls. Also Fraud risk.	
	A = L	Good budgetary controls.	
	V = n/a		
2. Cash	C = M	Fraud risk offset by budget process monthly.	
	E = M	Fraud risk.	
	A = L	Bank reconciliation and budget process monthly.	
	V = n/a		

Note: The valuation assertion was not considered relevant to SPEC's revenues and cash balance and has not been assessed.

Designing Further Audit Procedures

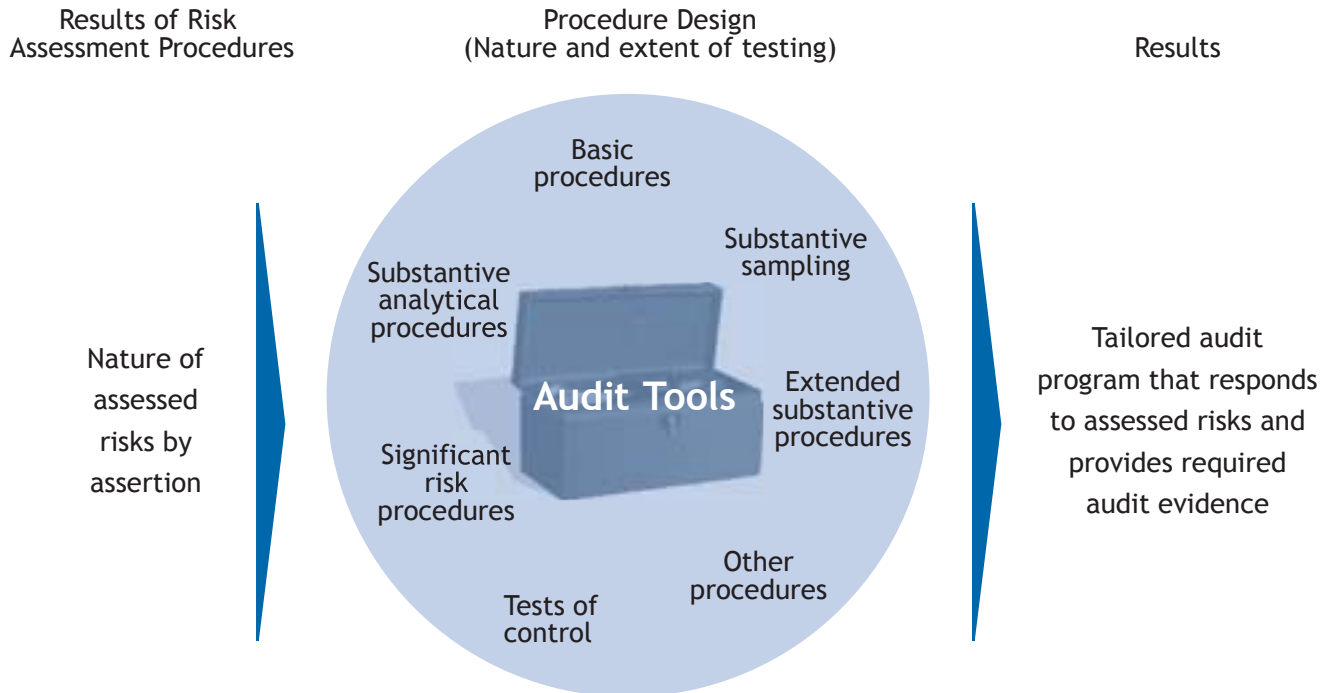
The next step in the audit process is to respond appropriately to the assessed risks (as summarized on Form 590 or equivalent documentation). This is performed by designing further audit procedures that will reduce the auditor's detection risk to an appropriately low level.

The goal is simply to develop customized procedures that address the specific risks identified.

- If the assessment of risk at the F/S level is high, then more work will be required for all F/S areas (because these are pervasive risks).
- Where the risk of material misstatement for a particular assertion is assessed as high, more work is required than for an assertion assessed as low risk.

Often, one of the more difficult parts of this process is to decide on the most appropriate mix of audit procedures in the auditor's toolbox. This process is illustrated below.

Responding to Assessed Risks



To facilitate this process, the .100 series and the 600 series of the PEM forms provide a one-page detailed plan for all the usual F/S areas. Form 700 provides some basic guidance on how to design the audit program. The possible mix of procedures has been addressed through the concept of evidence points. When developing the detailed plan, always consider the entire transaction stream (i.e., sales, receivables, receipts) and take appropriate credit for work done in one area that addressed an assertion in another.

Note: The evidence points were never intended (under any circumstances) to be a substitute for professional judgment. The points are no more than a starting point to guide the auditor in designing the appropriate mix of procedures. If the planned procedures depart from the PEM guidelines, simply provide a short explanation in the comments box below the table. In the next PEM update, we will revise the suggested guidelines for evidence points so that between 4 and 6 points are acceptable for a low risk assertion, between 7 and 8 for a moderate risk assertion and between 9 and 10 for high risk assertion.

CASE STUDY

For SPEC, Form 700 could be completed (in part) as illustrated below.

Revenues – Detailed audit plan

700

Entity SPEC
 Period ended December 31, 20XX

Assertions to be addressed: Completeness Existence Accuracy Valuation

Overall risk assessment (after considering any overall response to risks identified)	W/P ref.
What is the assessed risk of material misstatement (RMM) at the financial statement level? <u>M</u> (H,M,L)	

Detailed response planning Consider results from risk assessment procedures.	Yes/no	Implication of 'yes' responses	W/P ref.
1. Is this account class of transaction material?	Y	Assess RMM by assertion. (See detailed audit plan below.)	
2. Are there assertions that cannot be addressed by substantive tests alone?	N	Design tests of control for the relevant assertion(s).	
3. Are internal controls over related transaction streams/processes expected to be reliable? If so, could they be tested to reduce need/scope for other substantive procedures?	N	Design tests of control to provide a "moderate" or "low" level of control risk. Consider reliance on tests of control performed in past two years. Then reduce the level of assurance required from other substantive procedures.	
4. Are there substantive analytical procedures available that would reduce need/scope for other audit procedures?	N	Design "highly effective" or "moderately effective" substantive analytical procedures.	
5. Is there a need to incorporate an element of unpredictability or additional audit procedures (i.e., to address fraud, risk, etc.)?	Y	Select an appropriate "extended procedure" or design specific procedures to address the risk(s).	
6. Are there significant risks that require special attention?	Y	Design specific procedures to address the risk(s).	

DETAILED AUDIT PLAN	Suggested evidence points	Assessed risk of RMM by assertion (only circle the 4 columns that apply) Consider the impact of the overall risk assessment.											
		High risk				Moderate risk				Low risk			
		C	E	A	V	C	E	A	V	C	E	A	V
		10	10	10	10	8	8	8	8	6	6	6	6
Sources of Evidence													
Required procedures	4	4	4	4	4	4	4	4	4	4	4	4	4
Substantive procedures – Sampling	2 – 4												
Tests of control	2 – 3												
Substantive analytical procedures	2 – 3												
Extended substantive procedures	1 – 3					2							
Other specific procedures	1 – 2					2	2						
Total points for assertion	4 – 19					8	6					4	

Refer to Form 606 for guidance on how to complete the plan and for an explanation about evidence points.

Audit planning comments:
 The valuation assertion is not considered relevant for revenues.
 The basic procedures are considered sufficient to address the accuracy assertion for this client.
 The proposed 'other specific procedures' to address the identified fraud risk are considered sufficient to address existence.

Note: The detailed audit plan for revenues calls for substantive procedures.
 The 'extended substantive' and 'other specific procedures' address the specific risks summarized on Form 590.

Performing Procedures, Evaluating Results and Forming an Opinion

The final steps in the audit process are fairly straightforward. The key points to remember are:

- Everything needs to be documented. See Section 5145 of the *CICA Handbook – Assurance*;
- Take time to assess the results, the nature of evidence obtained and any indicators of potential fraud. Then respond appropriately before drawing any final conclusions; and
- Report audit findings to management and those responsible for governance (e.g., audit committee).

Moving Forward

Some key points to consider include:

1. Many aspects of the audit process require the auditor to use professional judgment. In fact, Sections 5141, 5143 and 5145 of the *CICA Handbook – Assurance* make numerous references to the use of ‘judgment’.
2. It is imperative that auditors use their experience and understanding of the entity before determining which PEM forms are applicable in each engagement.
3. Assessing risk and evaluating control design/implementation may be new skills for some auditors to learn. It is no longer possible to simply assess control risk at the maximum without first identifying and assessing risk factors.
4. Auditing standards are much more explicit now in the requirement to link the risks identified to the design of audit procedures, particularly at the assertion level.
5. The key PEM forms for recording and assessing data are the risk register and the risk control matrices. These forms may be customized as necessary for use in your office.
6. Many of the new PEM forms will take time to complete in year one but these will then be available to reuse in year two and onwards (after updating for changes, etc.).
7. Many of the PEM forms, once completed for a particular industry, can be used as a guide or template for other clients in the same industry or with similar characteristics.
8. The control procedures that cluttered the risk control matrices have been removed from the matrices included in PEM Update 37 and from the corresponding *PEM Electronic Templates* (Word and Excel). It is simpler to find out what the client actually does to mitigate the risks and then use their own words to record the nature of controls. A listing of standard control procedures can still be found (if necessary) on Form 580.
9. There are alternative ways of documenting and assessing required information that may be useful in some situations (e.g., memos to file, custom checklists and worksheets). However, caution should be exercised when using unstructured tools (particularly memos) to ensure that sufficient information is obtained, evaluated and documented to meet the requirements of the audit standards.
10. The key to developing a good audit plan is to link the design of further audit procedures as closely as possible to the risks they address.

Feedback

We encourage your feedback!

Send your comments or suggestions for future issues to one of the contacts listed below.

Stuart Hartley, FCA, CA•IT



Toronto, Ontario
Tel: (416) 594-0005
Fax: (416) 867-1906
www.FocusROI.com

Peter J. Hault, CA
Director, Information and
Productivity Resources
The Canadian Institute
of Chartered Accountants
Tel: (416) 204-3330
Fax: (416) 204-3414

Publisher
Peter J. Hault, CA

Authors
Stuart Hartley, FCA, CA•IT
FocusROI Inc.
Marcus A. Guenther, MBA, CA
FocusROI Inc.

Editor
Kathleen Aldridge, B.A., Dip. Ed.

The *Focus on PEM* newsletter is distributed to subscribers of the CICA's *Professional Engagement Manual* (PEM). *Focus on PEM* is published three times a year by:
The Canadian Institute
of Chartered Accountants
277 Wellington Street West
Toronto, M5V 3H2, Canada
Tel: (416) 977-3222
Fax: (416) 204-3414

The opinions expressed are those of the authors and not necessarily endorsed by the CICA.