# Maintaining an international standard

**Pesh Framjee assesses the impact of the international standards on auditing**

On 17 December 2004, the Auditing Practices Board (APB) published 30 new international standards on auditing (UK & Ireland) (ISA pluses) which will replace existing UK auditing standards (SASs) and align them with international auditing standards. The plus elements do two things – to incorporate elements of previous UK SASs where these are not covered by the existing ISA, and to include local legal requirements. While UK standards have historically included the requirements of existing ISAs, there have been several major changes in the last year which will mean significant new requirements for auditors and require them to overhaul their approach and methodology. The ISA pluses are effective for audits of accounting periods commencing on or after 15 December 2004.

In the longer term, APB will update Practice Note 11 which provides guidance on the application of auditing standards to the audit of charities in the United Kingdom. However, it recognised that in the short term there was a need for more urgent guidance on applying the new requirements to charities. Accordingly, on 17 February 2005 it published Bulletin 2005/1 entitled *Audit Risk and Fraud - Supplementary Guidance for Auditors of Charities*. This bulletin provides supplementary guidance for auditors of charities on these additional requirements, by replacing the relevant sections of APN 11. It focuses on the three ISA pluses that address the areas of audit risk and fraud:

- ISA (UK and Ireland) 240 - The Auditors' Responsibility to consider fraud in an audit of financial statements
- ISA (UK and Ireland) 315 - Understanding the entity and its environment and assessing the risk of material misstatement
- ISA (UK and Ireland) 330 – The auditor's procedures in response to assessed risks

### Fraud

ISA (UK and Ireland) 240 is establishes standards and provides guidance on the auditor's responsibility to consider fraud and expands on how the standards and guidance in ISA (UK and Ireland) 315 and ISA (UK and Ireland) 330 are to be applied in relation to the risks of material misstatement due to fraud. The standards and guidance are intended to be integrated into the overall audit process. In particular ISA (UK and Ireland) 240 makes the presumption that revenue recognition is a specific risk and requires the performance of certain audit procedures to address the risk of fraud due to management override of controls.

The ISA also requires that management (trustees in a charity) should represent that they have disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud. Trustees and management should not see this as box ticking exercise and will benefit from carrying out this assessment.

When training and lecturing on fraud I, half in jest, often say 'in God I trust – everyone else I audit'. The ISA emphasises the importance of professional scepticism and explains that although the auditor is not expected to disregard past experience of the honesty and integrity of management and those responsible for governance the attitude of professional scepticism should be maintained regardless of the auditor's past experience of the honesty and integrity of the client. The guidance clarifies that this is more than just mindset and the audit documentation will also need to demonstrate that this requirement has been met.

In February 2005 the Institute of Chartered Accountants in England & Wales published a guide *Auditing Standards – All Change! A Short Guide to Selected International Standards on Auditing (UK and Ireland)* to provide useful guidance and examples of responses to the new standards.

Using the guidance in its example of a pub chain as analogous to a charity shop operation the auditor would need to recognise the risk inherent in a cash based operation. The guide explains; 'The auditor would be required to consider how fraud might be perpetrated.. The auditor should to some extent 'think like a fraudster' and might consider the following questions:

i) How could sales be concealed or not 'rung-up' in order that cash receipts could be misappropriated?
ii) Could the electronic tills be tampered with?
iii) How are incorrect entries corrected?
iv) How are the assets physically secured?
v) Is there scope for collusion?'

The guide goes on to explain: 'It should be noted that not all staff will be experienced enough to perform this type of risk analysis. The assistance of senior managers or the audit partner might be required and extra training may be needed. This may come at a cost.'

**Risk**

ISA (UK and Ireland) 315 covers obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit. ISA (UK and Ireland) 330 covers the determination of overall responses and design and performance of further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit. The importance of the auditor's risk assessment as a basis for further audit procedures is discussed in the explanation of audit risk in ISA (UK and Ireland) 200, *Objective and General Principles Governing an Audit of Financial Statements*.

The most significant changes which will lead to a review of the audit approach are the need to gain a deeper understanding of the control environment and to evaluate the design of controls and determine whether they have been implemented. Prima facie, this may not appear different to the audit approach currently required by existing SASs. However, ISA (UK and Ireland) 315 goes on to more fully explain this requirement and it demands significantly more than the existing UK requirements.

Paragraph 43 of ISA (UK and Ireland) 315 explains that an auditor must obtain an understanding, consider and document each of the following five components of internal control.

i) Control environment (in the case of a charity there are many issues to consider from the tone at the top, the use of volunteers and the nature of activities)
ii) Entity's risk assessment process
iii) Information system, including the related business processes, relevant to financial reporting and communication
iv) Control activities
v) Monitoring of controls.

This may seem like stating the obvious but it is telling that the ICAEW guide explains that 'for many, this will represent one of the most significant changes from current working practices.'

For example, some work on internal control is now required regardless of whether the auditor tends to adopt a substantive audit approach and is not relying on controls. In the past many charity audits defaulted to a substantive approach and even where controls were reviewed there was little evidence documented that the controls were properly implemented. In the future the client and the auditor will have to focus more on controls especially where the accounts caption is a risk area (ISA plus 315 presumes that revenue recognition is a risk area) The ICAEW guide also clarifies that 'much of the information used in monitoring of controls is often produced by information systems. The auditor must determine whether the entity has a reasonable basis for relying on such systems.' This increases the need to use IT specialist auditors and this may become a norm.

PN11 refers to the use of analytical procedure and many charity auditors often rely on these procedures. Under ISA plus 330, analytical procedures are acceptable only if there is a low risk that a material misstatement may occur because of the particular characteristics of a class of transactions If the risk is considered low because controls are expected to be effective then the auditor is required to perform tests of the operating effectiveness of those controls. Where the auditor uses information provided by the client as the basis for analytical procedures this information cannot be accepted without corroborating evidence. So it is not enough to simply use management numbers without being satisfied as to their integrity.

The changes required by these standards have not yet received much publicity and, although the degree of change will vary from one audit to another, change is inevitable. It is important that clients and auditors understand this as it is likely that both will have to consider the new requirements as the bar has been raised. It is highly likely that there will be cost implications. The ICAEW guidance states: 'Audit engagement partners are encouraged to communicate the extent and nature of changes in their audit processes and procedures with those charged with governance and any increase in resources required to perform the audit in accordance with the new standards. Engagement partners also need to be satisfied that sufficient partners and staff have been assigned to meet these standards in full.'■

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