

Leveraging the Standards - Towards an Effective and Efficient Audit



In the current environment of increased regulatory oversight and stakeholder expectations along with increased pressure on audit fee levels, the economics of rendering audit services are being redefined. Considering this, it is not uncommon for an auditor to be overly conservative while performing their audit procedures. However, this zeal for compliance could result in inefficiencies with a common impression being carried that Standards on Auditing (SAs) require all such audit procedures to be undertaken. Audit teams may at times miss the avenues within the SAs that enable the auditor to think out of the box and make their audit plans more efficient and dynamic while retaining the effectiveness and quality of the audit. The purpose of this article is to serve as a refresher to fellow professionals as we all go about planning our audit engagements in the upcoming cycle. Read on...

Let us have a closer look at some of the specific avenues within the SAs and other guidance that would allow the auditor to incorporate efficiencies by either leveraging audit procedures performed in earlier periods or by relying on the work performed by others in specific areas without compromising on the quality of the audit. While evaluating these

avenues, the auditor needs to be mindful of the specific considerations included in the SAs and other guidance in this regard and exercise their professional judgment given the specific facts and circumstances of their audit engagement.

Leveraging Work Performed in Earlier Periods by the Auditor – What Do the Standards Say?

“SA 330 – *The Auditor’s Responses to Assessed Risks*” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement in a financial statement audit.

Along with guidance on the procedures the auditor should perform, the standard provides substantial guidance on situations where the auditor could rely



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on audit evidence obtained in prior audit periods while performing the audit of the current period. Within the SAs this seems to be a singular instance where certain audit evidence obtained for up to two prior audit periods is allowed to be leveraged for the audit of the current period. This, however, is limited to evidence obtained around operating effectiveness of controls.

Para 14 of the SA lays down certain considerations which the auditor needs to keep in mind while opting to leverage audit evidence on operating effectiveness of controls obtained up to two previous audit periods:

- The auditor should satisfy themselves of the continuing relevance of the said controls
- Confirm that no significant changes have occurred post the last testing conducted through inquiries combined with observation or inspection

If the controls continue to be relevant and there have been no significant changes, the auditor should test the controls at least once in every third audit while ensuring that some controls should be tested every year (commonly referred to as rotation of controls approach) to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

Para 15 of the SA specifies that controls addressing any significant risk need to be tested in each audit period and the above approach of leveraging audit evidence across audit periods is not permitted for such controls.

Drawing Reference from Guidance Note on Audit of Internal Financial Controls over Financial Reporting

While the SAs deal with audit of financial statements, the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Auditing and Assurance Standards Board (Guidance Note) lays down audit considerations to be applied

in cases where the auditor needs to issue a separate audit opinion on the entity's Internal Financial Controls Over Financial Reporting. The reporting requirement has since been modified requiring the auditor to opine on the internal financial controls with reference to financial statements.

Para 125 & IG 16 of the Guidance Note state that the statutory auditor may consider a rotation approach for testing of operating effectiveness of internal financial controls with reference to financial statements and the considerations to be applied are in line with those specified in SA 330.

Further, Para 126 and IG 7.6 to 7.12 of the Guidance Note also provide guidance around benchmarking of automated application controls. This refers to the auditor's ability to leverage testing performed over automated application controls in the prior year provided general controls over program changes, access to programs and computer operations are effective and continue to be tested. This approach also requires the auditor to be satisfied that the automated application controls have not changed since they were last tested.

A Practical Approach

Let's consider an example of how this guidance can be applied in practice:

A Ltd. is a manufacturing company with a single manufacturing location and strong well defined internal financial controls. This is a continuing audit engagement for the auditor who has gained an appropriate understanding of the entity and its environment identifying the following significant risks:

- Risk of Management Override of Controls
- Risk of Fraud in Revenue Recognition

Below is a summary of relevant manual controls for each process considered to be in scope by the auditor for testing of internal financial controls with reference to financial statements:

Description	Controls Addressing Risk of Management Override (Addressing a significant risk)	Controls over Revenue & Receivables Cycle (Addressing a significant risk)	Controls of Property, Plant & Equipment Cycle	Controls over Inventory Cycle	Controls over Payroll cycle	Controls over Purchase & Payables Cycle
Total Controls	10	20	10	15	20	15
Relevant Controls	6	10	4	10	10	12

*underlying assumption being that the controls remain relevant and there are no significant changes since they were tested in the prior audit period

In the given example, the auditor will be required to understand the process flows and test the design and implementation of controls for each audit period. However, for testing operating effectiveness of the controls, the auditor would need to test all relevant controls addressing significant risks i.e. 16 controls in each audit period (covering risk of management override and revenue and receivables cycle).

For the other relevant controls, aggregating to 36 controls, the auditor can apply rotational approach for testing their operating effectiveness such that these controls are tested once in 3 years while ensuring that at least some controls are tested every year. One of the alternatives would be to test relevant controls in any 2 cycles in 20x1 (assuming that is the first year of adopting this approach on the continuing audit client), followed by testing of relevant controls in 1 cycle each in year 20x2 and year 20x3. Thus ensuring that all relevant controls across processes are tested at least once in a 3 year period thereby helping the auditor stagger the effort thereof over a 3 year period as against testing each of the 36 controls every year. However, the auditor would continue to annually test all relevant controls addressing a significant risk.

The decision of which controls to test in which year and how many to test in a particular year are all matters of professional judgement and the auditor will need to consider various factors like effectiveness of IT General Controls, past experience of testing the controls, risk of material misstatement and the extent of reliance on the controls while applying this approach.

Reliance on the Work of Internal Auditors – What do the Standards Say?

The Standards provide guidance in significant amount of detail to enable an auditor to determine as to whether the work of Internal Auditors can be used for the purposes of his audit opinion. However, this approach has largely remained unexplored with very few audit teams adopting this in a consistent manner.

“SA 610 – *Using the work of Internal Auditors*” provides specific guidance to the auditor around considerations to be applied if the auditor is planning to place reliance on work performed by the Internal Auditor.

Para 7 of SA 610 refers to guidance in SA 315 around how the knowledge and experience of the

Internal Auditor can inform the external auditor’s understanding of the entity and its environment and identification and assessment of risks of material misstatement.

However, Para 15 & 16 aim to take this a step further and indicate certain items to be evaluated by the external auditor while determining whether the work of the internal audit function can be used for purposes of the audit:

- Organisational status of the internal audit function and the extent to which it supports the objectivity of the internal auditors; an example of this would be to check whether the internal audit function reports directly to “Those Charged With Governance” as against reporting to an Executive function
- Level of competence of the internal audit function
- Approach applied by the internal audit function in carrying out its responsibilities; this would require the external auditor to evaluate as to whether the internal audit function applies a systematic, disciplined and rigorous approach including measures adopted to ensure quality control.

The Standards provide guidance in significant amount of detail to enable an auditor to determine as to whether the work of Internal Auditors can be used for the purposes of his audit opinion. However, this approach has largely remained unexplored with very few audit teams adopting this in a consistent manner. SA 610 – Using the work of Internal Auditors provides specific guidance to the auditor around considerations to be applied if the auditor is planning to place reliance on work performed by the Internal Auditor.

Para 17 & 18 of SA 610 further specify that the external auditor should consider the nature and scope of work performed/to be performed by the internal audit function and its relevance to the external auditor’s overall strategy and plan. The external auditor should ensure that all significant judgements in the audit are retained by the external auditor and the areas where reliance on internal audit work is being considered should not be where the external auditor has assessed the risk of material misstatement to be higher or significant.

Further, as mentioned in Para 21 & 23 of SA 610, the external auditor should discuss the planned use of work with the internal audit function and should determine the adequacy of the work done by the internal auditor including evaluating whether:

- The work of the internal audit function has been properly planned, performed, supervised, reviewed and documented.
- Sufficient appropriate audit evidence has been obtained to enable the function to draw reasonable conclusions, and
- Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of work performed.

Drawing a reference from the Guidance Note on Audit of Internal Financial Controls over Financial Reporting

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Para 82 of the Guidance Note provides that the auditor should evaluate the extent to which they will use the work of others to reduce the work the auditor might otherwise perform himself or herself. This Para specifically states that SA 610 "Using the work of Internal Auditors" and SA 620 "Using the work of an Auditor's expert" apply in a combined audit of internal financial controls over financial reporting and audit of financial statements.

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However, Para 84 of the Guidance Note also specifies that the auditor needs to assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater the use the auditor may make of the work. The said paragraph further specifies the elements the auditor should evaluate while assessing the objectivity and competence of those whose work the auditor is looking to rely upon.

Further, the Guidance note also explains that the extent to which the auditor may use the work of others in an audit of internal financial controls over financial reporting also depends on the risk associated with the control or area being tested. As the risk associated with a control or area increases, the need for the auditor to perform his or her own work on the control or area increases.

In the event the auditor chooses to rely on the work performed by others, an in depth evaluation of the following would need to be undertaken:

- To what extent should the work of others be used.
- Whether such work is adequate for the purposes of the audit and if so, the planned effect of such work on the nature, timing and extent of the auditor's work.

A Practical Approach

The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different to the extent they relate to financial statements, the manner in which the internal audit function and the external auditor achieve their respective objectives may be similar.

Para A16 of SA 610 provides certain examples where work of the internal audit function can be used by the external auditor:

- Testing of the operating effectiveness of controls
- Substantive procedures involving limited judgment

- Observation of inventory count
- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600)

If the external auditor decides to use the work of the internal audit function, it is imperative that the external auditor's communication to "Those Charged with Governance" specifically includes how the work of the internal audit function is planned to be used for the purposes of the external audit. (Para 20 of SA 610)

The external auditor should always bear in mind that even if the work of the internal audit function is used for the purposes of the external audit, the overall responsibility for the opinion expressed still rests with the external auditor. (Para 19 of SA 610 & Para 83 of the Guidance Note on Audit of IFCFR)

Based on the guidance that is available in SA 610 as well as the Guidance Note, it should be possible for the external auditor to use some work of the internal auditor provided the external auditor is able to positively conclude on the objectivity, competence and the appropriateness of the work performed by the internal audit function and the conclusions drawn therefrom.

Relevance for the Audit Professionals

As is evident, both the approaches referred to above emanate from the SAs and the Guidance Note on Audit of Internal Financial Controls over Financial Reporting (IFCFR) and hence are available to the auditor while planning the audit approach for upcoming audit engagements.

Adoption of both these approaches i.e. testing of certain internal financial controls with reference to financial statements for operating effectiveness on a rotational basis and / or using the work of the internal audit function for part of the audit work, will help the auditor achieve efficiencies in the

audit of routine controls which have not undergone a significant change and the other less complex and judgmental areas.

Needless to say, the expectation would be that the auditor utilises the efficiencies generated towards applying higher focus and rigour in performing other critical audit procedures, including testing of significant judgements and estimates that have been used by management and testing of relevant controls addressing significant risks. In summary, adoption of some of these measures can help enhance the audit quality in addition to bringing in engagement efficiencies.

Things to Consider

SA 330 and the Guidance Note permit the auditor to achieve certain efficiencies by leveraging audit evidence obtained in prior audit periods, specifically around testing of operating effectiveness of internal controls. Further, SA 610 and the Guidance Note permit the auditor to rely on work of the internal audit function for certain areas which are not assessed as higher or significant risk and those that are less judgmental.

However, opting for either or both of the above mentioned approaches should be done with the appropriate professional judgment and skepticism especially in the process of applying the considerations as laid down in SA 330, SA 610 and the Guidance Note to ensure that the audit engagement while being efficient also

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remains fit for purpose, continues to be effective and in compliance with the requirements of the Standards on Auditing and the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. ■

References: SA 330, SA 610, Guidance Note on Audit of Internal Financial Controls over Financial Reporting – all issued by the ICAI