

Preliminary assessment, inherent risk and key assertions of an audit essay sample...

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Question 1

a) Identify the factors that would affect the preliminary assessment of inherent risk and control risk at Queen Island Dairy. The preliminary assessment of risk, also known as the risk assessment phase, is the initial step in an audit that includes gaining an understanding of the client and identifying potential risk factors whilst developing an audit strategy and setting planning materiality. There are three key steps in the risk assessment phase, being; gaining an understand of the client, identifying potential risks and strategies to prevent or control such risks, and risk and materiality assessment. As by this definition there are a few identifiable risks within Queen Island Dairy. Inherent risk is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls. Control risk is the risk that a client's system of internal controls will not prevent or detect a material misstatement.

Upon a preliminary assessment it appears that the manufacturing process of Queen Island Dairy is upheld to an extremely high standard. This is evidenced through dedicated staff, high product quality, and extremely high standards of food handling and storage. This aspect of Queen Island Dairy has less apparent inherent and control risk than the paperwork side of the business. It has been suggested that Jim Bannock has been poorly documenting some business processes and disputes with customers, making frequent adjustments to debtor accounts using credit notes to deal with customer complaints (which is not the correct way to deal with customer complaints). This suggests an apparent increase in inherent and control risk

within the business, as there do not appear to be any preventative measures in place that would help to reduce inherent and control risk from occurring.

Also there is a lack of separation of duties within the company, which increases the control risk within the entity. A high detection risk should be set before starting this audit, as the audit risk is high. A high audit risk occurs when there is a high inherent risk, high control risk and low detection risk. Detection risk is the risk that the auditor's testing procedures will not be effective in detecting a material misstatement. An inverse relationship exists between detection risk and risk of material misstatement. Therefore if a high inherent and control risk exists the auditor will set detection risk as low to ensure that intensive testing is undertaken when the audit is conducted.

b) Explain how these factors would influence your choice between the predominantly substantive approach and the lower assessed level of control risk approach for sales, inventory and debtors. After conducting a preliminary assessment of the risk of material misstatement the auditor needs to determine the appropriate strategy for the rest of the audit. This can either be a predominantly substantive approach or the lower assessed level of control risk. Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. The predominantly substantive approach is adopted in cases where there is a high control risk, e. g. when: there are limited to no significant control procedures that pertain to assertion, relevant control procedures already in place are ineffective, and it would not be efficient to perform a test of controls.

This often occurs in small entities that do not implement appropriate controls or have ineffective control methods in place, due to the lack of separation of duties. The design of substantive procedures depends on the level of detection risk, which in this case is low. Therefore this requires a predominantly substantive audit strategy rather than a lower assessed level of control risk approach. The lower assessed level of control risk sees the auditor first testing the control procedures of an entity. This decision is an easy one for an auditor to make when considering the factors of potential risk outlined in part a.

Question 2

a) What key assertions for the above accounts are likely to be affected? “

Audit assertions are the implicit or explicit claims and representations made by the management responsible for the preparation of financial statements regarding the appropriateness of the various elements of financial statements and disclosures” (Accounting Simplified, 2013). There are five key assertions used for transactions and events that occur in the income statement during the accounting period. They are occurrence, completeness, accuracy, cut-off, and classification. On top of these assertions there are four more that are used when testing balance sheet items (existence, rights and obligations, completeness, and valuation and allocation) and an additional four used when testing what is disclosed in the financial report (occurrence, rights and obligations, completeness, classification and understandability, and accuracy and valuation).

The four accounts that the assertions apply to in this question are the two asset accounts of aircrafts and engines (seen in the balance sheet) and the two expense accounts of maintenance and depreciation (seen in the income statement). The key assertions likely to be affected are the income statement assertions of occurrence, completeness, accuracy, cut-off, and classification as well as the balance sheet assertions of existence, rights and obligations, completeness, and valuation and allocation. When testing for occurrence, the auditor searches for evidence to show that transactions and events have been recorded have occurred and are related to the entity. When testing for completeness, an auditor looks for evidence to prove that all transactions and events that should have been recorded have been recorded. When testing for accuracy, the auditor seeks out evidence to demonstrate that all amounts and other data relating to recorded transactions and events have been appropriately recorded.

When testing for cut-off, an auditor searches for evidence to establish that all transactions and events have been recorded in the correct accounting period. Similarly, when testing for classification, an auditor searches for evidence to establish that all transactions and events have been recorded in the correct account. When testing for existence, the auditor looks for evidence to verify that all assets, liabilities and equity interests exist. When testing for rights and obligations, an auditor seeks out evidence that the entity holds or controls the rights to assets, and liabilities are the obligations of the entity. Again the completeness assertion applies here for the asset accounts. When testing for valuation and allocation, the auditor searches for evidence to prove that assets, liabilities and equity interests are included in

the financial report at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded. (Moroney, Campbell, & Hamilton, 2014) b) Explain what evidence would be persuasive in this case.

As with every single audit, sufficient appropriate evidence must be found in order to make a persuasive case. Sufficiency relates to measure of quantity of evidence. The quantity of audit evidence required is influenced by: – Risk of material misstatement (as this risk increases, the quantity of evidence required also increases) – Quality of the audit evidence obtained (as the quality increases the need for more evidence decreases). Quality of evidence obtained is also known as appropriateness (PCAOB, 2010). To determine the level of evidence required, the risk level must be considered. There are three types of evidence that auditors will consider using: internally and externally generated evidence held by the client, and externally generated evidence sent directly to auditor. Internally generated evidence is any information or documents created by the clients e. g. debtor's invoices and purchase orders. Externally generated evidence is information created by a third party e. g. bank statements and supplier's statements. These two types of evidence can come in many different forms such as: – Electronic evidence

- Physical evidence
- Computational evidence
- Verbal evidence
- Representations
- Documentary evidence, and
- External confirmations (both positive and negative)

It is stated in the question that the auditor has been provided with the company's financial statements for the relevant accounting periods. This is not considered as satisfactory appropriate evidence as a company's financial statements are usually internally generated, or prepared by accountants who prepare them based on the company's internally generated reports. The auditor would have to compare the financial statements with externally generated forms of evidence in order to make it persuasive. These could include but are not limited to: bank statements, bank confirmation letter, management representation letter, computational evidence, and physical evidence by way of inspecting the inventory at the company to ensure it exists.

Question 3

a) Make a list of the potential problems that could occur in Powersys' Maintenance and improvements program. – A glitch in the communication system could stop reports reaching the 24-hour response teams in a timely manner – Storms and other natural disasters are more extensive than anticipated, leaving a shortage of staff and equipment – Purchases are made and not recorded correctly in the general ledger – Inventory is not purchased in a timely manner or is not purchased as required – Inventory is recorded in the balance sheet that does not exist – Equipment is not operational due to lack of maintenance

– Changes in technology could mean that Powersys are using outdated equipment b) Suggest ways that good internal control over parts, equipment and labour could help Powersys' avoid these problems. – Powersys should

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hire IT consultants who between them are available or “ on-call” 24 hours a day, seven days a week. This would ensure that if an error or glitch occurred in the communication system or any other system, an IT consultant would be available to help within minutes. – Scientific research as to the likely occurrence of natural disasters within the coming 12 months should be undertaken by a professional at least every six months so that Powersys can prepare for peak times and slow times.

– Purchase orders, delivery documents, and supplier’s invoices should be checked against each other on a monthly basis. – Someone should be hired into the position of inventory management to ensure that inventory levels remain consistent and inline with the firm’s current position (peak or trough). – Stocktakes should be performed on at least a quarterly basis. – Maintenance for machines should be scheduled as per manufacturers guidelines and then upheld consistently. – It is the responsibility of the IT consultants to ensure that Powersys stays up to date with the latest technologies in their sector.

Bibliography

Accounting Simplified. (2013). Assertions in the Audit of Financial Statements. Retrieved September 14, 2014, from Accounting-Simplified: [accounting-simplified. com/audit/introduction/audit-assertions. html](http://accounting-simplified.com/audit/introduction/audit-assertions.html)

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