Responding to assessed risks

MODULE 2 | 2.8 | STUDENT COMPANION

The aim is sufficient appropriate evidence about the assessed risks, through responses designed for them. Risks at the **financial statement level** get **overall responses**; risks at the **assertion level** get **further audit procedures**: tests of controls where the auditor relies on controls or substantive work can't do the job alone, and **substantive procedures for every material item, always**. **Significant risks** need specifically responsive substantive procedures, and any controls relied on must be tested this year.

Two levels of risk, two kinds of response

Level of risk	Response	Example at Voltana
Financial statement level: affects many assertions at once	Overall responses, chosen by the engagement partner	The new system and the pressure on revenue: an experienced senior on revenue, specialists, more year-end work
Assertion level: a particular class of transactions, balance or disclosure	Further audit procedures, with nature, timing and extent fitted to the risk	Revenue cut-off: testing sales either side of 30 June

Overall responses to financial statement level risks

1. **Scepticism** — Emphasise to the team the need for professional scepticism
2. **The right people** — More experienced staff, specialised skills, or experts
3. **Supervision** — Closer direction and review of the team's work
4. **Unpredictability** — Procedures the client won't expect
5. **Nature, timing, extent** — More work at year end, less at an interim date; more substantive evidence

At Voltana

Risks at the financial statement level
The new system, and the pressure on revenue

→

The partner's overall responses

- The most experienced senior assigned to revenue
- An IT specialist and an engineer involved
- More year-end testing than in past years

Tests of controls and substantive procedures

Tests of controls

- Evaluate whether controls **operated effectively throughout the period**
- **Required when** the risk assessment expects controls to work, so the auditor intends to rely on them
- **Required when** substantive procedures alone can't give enough evidence, as in highly automated processes with no paper trail

Substantive procedures

- Look directly for material misstatements: **tests of details** and **substantive analytical procedures**
- **Always required** for every material balance, class of transactions or disclosure, whatever the risk assessment
- **On every audit:** agree the statements to the underlying records, and examine the material journal entries and adjustments made in preparing them

Good controls reduce substantive work; they never remove it

Risk assessment is a judgement that might be wrong, and controls have limits, such as override and collusion

If a control works perfectly, can substantive work stop? No. The risk assessment is a judgement that might be wrong, and controls have inherent limits, including override and collusion, so every material item still needs some substantive evidence. Good controls reduce the amount; they never remove it. Two substantive procedures are required on every audit regardless: agreeing the financial statements to the underlying records, and examining the material journal entries and adjustments made while preparing them.

Significant risks: the special rules

At Voltana, revenue cut-off and occurrence (with the presumed fraud risk and the June spike) and the warranty provision (with its wide range) are both significant risks.

Rule	Why
Substantive procedures that respond specifically to the risk	General procedures may miss the way this particular misstatement would happen
If relying on substantive procedures alone, they must include tests of details	Analytical procedures alone rarely give enough evidence for the riskiest items
Controls relied on over a significant risk must be tested in the current period	Evidence from earlier audits isn't enough

Timing and extent

Choice	What the standard expects
Testing at an interim date	Efficient, but the remaining period to year end must then be covered by further substantive procedures, either combined with tests of controls for that period or on their own if they are enough. Tests of controls alone can't cover the gap
Higher risk	Prefer testing at or near the year end
Extent	Increases with risk: larger samples, or analytics over the whole population
Dual-purpose tests	One procedure on the same document does both jobs: checking an invoice for evidence of approval (a test of control) and agreeing its amount (a test for misstatement)

Smaller entities. With few formal controls and little segregation of duties, testing controls is rarely efficient or even possible, so the auditor usually takes a predominantly substantive approach: strong substantive analytics where reliable data exists, and detailed testing of the material balances. The owner-manager's involvement can strengthen some controls but raises the risk of override, which journal entry testing and a careful review of unusual transactions address.

Voltana's risk-response plan

Risk	Identified in	Planned response
Revenue occurrence and cut-off Significant risk	2.6.1, 2.7.3	Match a sample of June sales to signed installation completion forms and customer acceptance; examine every manual revenue entry posted near year end; test sales recorded in the two weeks either side of 30 June; review credit notes and reversals issued after year end
Warranty provision Significant risk	2.6.2	Develop the team's own range with the engineer; examine claims paid after year end; review last year's estimate against what happened
Inventory	2.7.2	Attend the stocktakes; test the costing; compare carrying amounts with prices achieved after year end, especially for older models
New system	2.5.2	Reconcile the migrated balances; test access and change controls in the new environment
Related parties	2.6.2	Inspect the lease and its approval; obtain the valuation evidence; check the disclosures
Going concern	2.6.3	Evaluate management's cash flow forecast and the bank's position on refinancing
Management override Significant risk	2.6.1	Test journal entries; review estimates for bias; evaluate any unusual transactions

Every line traces back to a risk identified in this module

Practice questions

MODULE 2 | 2.8 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - A finance team that turned over

Corrowong Irrigation Ltd (imagined), a listed maker of irrigation systems for farms, lost its chief financial officer, financial controller and both senior accountants between March and May, after a dispute with the new chief executive. Contractors and two new hires closed the June accounts. Last year's audit relied on controls run by the people who have left. Choose the overall responses you would make, and explain why.

Question 2 - Are tests of controls required?

Situation	Required?	Why?
(a) A bank processes millions of card transactions automatically, with no paper record, and the auditor can't get enough evidence from substantive procedures alone		
(b) A small retailer's owner does almost everything; a fully substantive approach on the material balances will give enough evidence		
(c) To reduce sample sizes, the auditor's risk assessment assumes the purchase authorisation control works		
(d) Controls over a significant risk (valuing complex derivatives) were tested last year and haven't changed; the auditor wants to rely on them again		

Question 3 - A significant risk in software revenue

Quillfeather Software Ltd (imagined) sells three-year contracts: a software licence delivered at the start, plus three years of support and updates. Each year is invoiced in advance. Licence revenue is recognised on delivery and support over time. Sales staff earn commission on total contract value, and several large contracts were signed in the last week of June. Revenue is a significant risk: design the response.

Risk or assertion	Procedure	Why it responds to the risk

Worked answers

MODULE 2 | 2.8 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Corrowong Irrigation (sample answer)

- **Emphasise scepticism.** New people, an unfamiliar close and a boardroom dispute: errors are more likely, and the departures themselves need explaining. Ask why they left and whether they disagreed with any accounting.
- **Assign experienced staff and more supervision.** Put an experienced senior on the year-end close, journals and estimates; more manager and partner review; specialists if system knowledge left with the staff.
- **Change the nature, timing and extent.** Last year's reliance on controls no longer holds, so plan a mainly substantive approach, more work at year end, larger samples, more external evidence, and a full review of reconciliations and judgements prepared by the contractors.
- **Add unpredictability** and discuss the plan with those charged with governance.

Question 2 - Tests of controls

	Required?	Why
(a)	Yes	Substantive procedures alone can't provide sufficient appropriate evidence
(b)	No	No reliance on controls is planned, and substantive procedures are enough
(c)	Yes	The risk assessment expects the control to work, so reliance must be supported
(d)	Yes, this year	Controls over a significant risk must be tested in the current period

Question 3 - Quillfeather Software (suggested)

Because revenue is a significant risk, the response must include tests of details; analytics alone won't do. If the team relies on contract approval controls, it must test them this year, and it examines manual revenue journals near year end.

Risk or assertion	Procedure	Why it responds
Occurrence and cut-off of June contracts	For every large June contract, inspect the signed contract and evidence the licence was delivered by 30 June (activation or download logs); confirm terms directly with customers	Commission and the late signings create pressure to record licences early or invent sales
Side agreements and reversals	Ask sales staff and management about side letters; review credit notes, cancellations and refunds after year end	Hidden rights to cancel change when, or whether, revenue can be recognised
Accuracy of the split between licence and support	Test the stand-alone selling prices used and recalculate the allocation for a sample	Shifting price to the licence brings revenue forward
Deferred revenue	Recalculate the support revenue earned and deferred, and agree invoices billed in advance to the deferred balance	Annual invoicing in advance must not become revenue early