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Bachelor of Commerce (B2001) | Level 3 • Part B Major | Monash University

Auditing and assurance

Course Code: ACC3600 • Module 2 Notes

Module 2: Audit Planning, Risk Assessment & Materiality

Chapter 1: The Modern Risk-Based Audit Approach & Client Acceptance

1.1 The Risk-Based Auditing Paradigm

Modern financial report auditing has evolved from historical procedural checklists and exhaustive transaction verification into a sophisticated, top-down, risk-based methodology codified in ASA 300 (Planning an Audit of a Financial Report) and ASA 315 (Identifying and Assessing the Risks of Material Misstatement). Risk-based auditing recognizes that business entities operate in complex, volatile commercial environments where risks of misstatement are not distributed uniformly across financial statement line items. Attempting to test all ledger entries equally is economically inefficient and fails to detect sophisticated accounting manipulations.

Under the risk-based approach, the auditor directs maximum professional resources and rigorous substantive procedures toward financial statement areas possessing the highest inherent risk and vulnerability to material misstatement—such as subjective valuation estimates, complex revenue recognition contracts, goodwill impairment models, and management override of internal controls—while applying streamlined testing to routine, low-risk operational cycles supported by robust automated IT controls.

1.2 Client Acceptance and Continuance Procedures

Audit planning begins prior to signing the formal engagement letter. Under ASQM 1 and ASA 220, an audit practice must perform rigorous client acceptance (for prospective new clients) and continuance evaluations (for existing recurring engagements) before committing professional resources. The acceptance framework assesses four critical dimensions:

1. **Integrity of Governance and Executive Leadership:** An auditor cannot conduct an effective audit if corporate management lacks integrity. Auditors evaluate management's commercial reputation, history of corporate litigation, regulatory sanctions by ASIC or the Australian Taxation Office (ATO), attitudes toward aggressive tax structuring, and willingness to accept audit adjustments. If an entity's leadership demonstrates disregard for compliance or hostile resistance to transparent disclosure, the engagement must be declined.
2. **Audit Firm Competence, Capabilities, and Resources:** The firm must possess the industry-specific expertise, technical capabilities, and personnel necessary to execute the audit in accordance with professional standards and statutory deadlines. For instance, auditing a major Australian mining conglomerate requires specialized knowledge of rehabilitation provisioning (AASB 137), Joint Ore Reserves Committee (JORC) resource classifications, and derivative commodity hedging under AASB 9.
3. **Compliance with Ethical and Independence Requirements:** The engagement partner must verify that the firm and all proposed engagement team members comply with APES 110 independence standards. This includes clearing personal financial investments, checking business

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relationships, ensuring partner rotation compliance under s. 324DA of the Corporations Act 2001, and identifying any prohibited non-audit services.

4. **Communication with the Predecessor Auditor:** Under APES 110 s. 320, when approached to replace an existing auditor, the proposed incoming auditor must request client permission to communicate with the incumbent auditor. The inquiry seeks to ascertain whether there are any professional or ethical reasons why the appointment should not be accepted, such as unresolved disputes over accounting policies, management integrity deficiencies, or unpaid professional fees. If the client refuses to authorize communication, the incoming auditor should ordinarily decline the appointment.

1.3 The Formal Audit Engagement Letter (ASA 210)

Once client acceptance is confirmed, ASA 210 (Agreeing the Terms of Audit Engagements) mandates that the agreed terms of the audit engagement be documented in a written engagement letter. The engagement letter functions as an enforceable legal contract, preventing misunderstandings regarding the scope and boundaries of the audit. Under ASA 210, the letter must explicitly define:

- The objective and statutory scope of the financial statement audit under the Corporations Act 2001;
- The responsibilities of the independent auditor, emphasizing that the audit provides reasonable (not absolute) assurance that the financial statements are free from material misstatement;
- The responsibilities of management and those charged with governance—specifically, responsibility for preparing financial statements in accordance with Australian Accounting Standards, designing and maintaining effective internal controls, and providing unrestricted access to all records, documentation, and personnel;
- Identification of the applicable financial reporting framework (e.g. Australian Accounting Standards and IFRS); and
- Reference to the expected form and content of reports to be issued, alongside explicit notification that the final opinion may differ if unexpected material issues emerge during field testing.

Chapter 2: Understanding the Entity & Assessing Risks of Material Misstatement (ASA 315)

2.1 The Top-Down Environmental Risk Framework

To identify where material misstatements are most likely to occur, ASA 315 requires the auditor to obtain an in-depth understanding of the entity and its environment through five interconnected operational lenses:

Analytical Lens	Key Areas of In-Depth Investigation	Financial Statement Risk Implications
1. External Industry & Regulatory Environment	Macroeconomic conditions (RBA cash rate cycles, inflation, AUD/USD exchange rate volatility), industry competitive dynamics, supply chain disruptions, regulatory oversight (ASIC, ACCC, APRA, EPA).	Rising interest rates increase borrowing costs and increase impairment risks for goodwill and capitalised intangibles (AASB 136). Rapid technological shifts create inventory obsolescence risks (AASB 102).

Analytical Lens	Key Areas of In-Depth Investigation	Financial Statement Risk Implications
2. Nature of the Entity & Operating Structure	Operational complexity, revenue models, key customer concentrations, major supplier dependencies, related-party networks, geographical footprint, capital structure.	Complex multi-element customer contracts increase revenue recognition misstatement risks under AASB 15. Unrecorded related-party transactions threaten disclosure completeness (AASB 124).
3. Selection & Application of Accounting Policies	Management choices regarding subjective accounting estimates, revenue recognition criteria, capitalization thresholds for development assets, depreciation methodologies.	Aggressive revenue acceleration, premature milestone sign-offs, or understating expected credit loss provisions under AASB 9 to boost reported earnings.
4. Objectives, Strategies & Commercial Risks	Corporate strategic plans, rapid expansion through leveraged mergers and acquisitions, capital expenditure budgets, digital transformation initiatives.	Aggressive acquisition strategies increase risks of misallocated purchase price accounting and overvalued intangible assets under AASB 3.
5. Measurement & Review of Financial Performance	Key performance indicators (KPIs), analyst consensus forecasts, executive short-term and long-term incentive hurdles, debt covenant compliance ratios.	Severe managerial pressure to manipulate earnings when operating profit approaches debt covenant thresholds (e.g. interest coverage ratio $< 2.5\times$).

2.2 The Audit Risk Model

The Audit Risk Model provides the foundational conceptual and quantitative framework guiding audit resource allocation and substantive test design. Codified in ASA 200 and ASA 315, the model expresses the relationship between the components of audit risk:

$$\text{Audit Risk (AR)} = \text{Risk of Material Misstatement (RMM)} \times \text{Detection Risk (DR)}$$

Because the Risk of Material Misstatement exists independently of the audit and is a function of the entity's operating realities and internal control design, RMM decomposes into two distinct operational components:

$$\text{RMM} = \text{Inherent Risk (IR)} \times \text{Control Risk (CR)}$$

$$\text{Audit Risk (AR)} = \text{Inherent Risk (IR)} \times \text{Control Risk (CR)} \times \text{Detection Risk (DR)}$$

Where:

- **Audit Risk (AR):** The risk that the auditor expresses an inappropriate unqualified audit opinion when the financial report is materially misstated. The auditor sets Audit Risk at an acceptably low level (typically 1% to 5%) based on professional standards and external user reliance.
- **Inherent Risk (IR):** The susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. Inherent risk is driven by transaction complexity, measurement subjectivity (e.g. fair value estimates), asset susceptibility to theft, and external economic turbulence.
- **Control Risk (CR):** The risk that a misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity's internal control system. Control risk is a function of the effectiveness of internal control design and operation.
- **Detection Risk (DR):** The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material. Unlike IR and CR, Detection Risk is entirely controllable by the auditor through the nature, timing, and extent of substantive audit procedures.

Inverting the audit risk equation allows the auditor to solve for the acceptable level of Planned Detection Risk ($\mathrm{DR}_{\mathrm{planned}}$) necessary to achieve the target Audit Risk:

$$\mathrm{DR}_{\mathrm{planned}} = \frac{\text{Audit Risk (AR)}}{\text{Inherent Risk (IR)} \times \text{Control Risk (CR)}} = \frac{\mathrm{AR}}{\mathrm{RMM}}$$

The mathematical relationship dictates an inverse relationship between assessed RMM and Planned Detection Risk: when Inherent Risk and Control Risk are assessed as high, Planned Detection Risk must be set low. To achieve a low Detection Risk, the auditor must perform more rigorous, extensive, and timely substantive testing (e.g. testing at year-end rather than interim, selecting larger sample sizes, and relying on external corroboration rather than internal inquiry).

2.3 Worked Numerical Example: Quantitative Calibration of Planned Detection Risk

An Australian audit team plans the statutory financial statement audit of an ASX-listed national logistics corporation. The engagement partner establishes an overall acceptable Audit Risk of $\mathrm{AR} = 0.05$ (5.0%). The audit team evaluates two distinct balance sheet accounts:

1. **Account 1: Trade Accounts Receivable**
   - The company operates in a stable domestic retail freight market with standardized invoicing, high turnover, and predictable collections. Inherent Risk is assessed as Moderate: $\mathrm{IR} = 0.40$ (40%).
   - The entity possesses highly automated ERP invoicing controls, three-way electronic matching, and automated credit limit enforcement. Following walk-throughs and preliminary tests of controls, Control Risk is assessed as Low: $\mathrm{CR} = 0.25$ (25%).
   - Combined Risk of Material Misstatement:

$$\text{RMM} = \text{IR} \times \text{CR} = 0.40 \times 0.25 = 0.10 \quad (10.0\%)$$

- Required Planned Detection Risk:

$$\text{DR}_{\text{planned}} = \frac{\text{AR}}{\text{RMM}} = \frac{0.05}{0.10} = 0.50 \quad (50.0\%)$$

- *Audit Strategy:* Because planned detection risk is high (50.0%), the auditor adopts a combined audit strategy. The auditor relies extensively on automated controls testing and executes moderate substantive analytical procedures and limited sample debtor confirmations at an interim date.

2. **Account 2: Development Intangible Assets & Goodwill**
   - The company capitalized \$85 million in proprietary logistics software algorithms and carries \$140 million in goodwill from recent acquisitions. The valuation relies on discounted cash flow (DCF) models with subjective discount rates and terminal growth assumptions. Inherent Risk is assessed as High: $\text{IR} = 0.90$ (90%).
   - Management lacks formal valuation controls, fails to back-test historical forecasts against actual cash flows, and executive bonuses are directly tied to earnings before interest and tax (EBIT). Control Risk is assessed as High: $\text{CR} = 0.80$ (80%).
   - Combined Risk of Material Misstatement:

$$\text{RMM} = \text{IR} \times \text{CR} = 0.90 \times 0.80 = 0.72 \quad (72.0\%)$$

   - Required Planned Detection Risk:

$$\text{DR}_{\text{planned}} = \frac{\text{AR}}{\text{RMM}} = \frac{0.05}{0.72} \approx 0.0694 \quad (6.94\%)$$

   - *Audit Strategy:* Because planned detection risk must be kept exceptionally low ($< 7.0\%$), the auditor adopts a purely substantive audit strategy. The auditor engages an independent valuation specialist (under ASA 620), tests 100% of DCF model inputs at year-end, performs rigorous sensitivity stress-testing on discount rates, and reviews historical forecasting variance.

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Chapter 3: Materiality in Planning & Performing an Audit (ASA 320 & ASA 450)

3.1 The Concept of Materiality

Materiality is an essential consideration throughout every phase of an audit. ASA 320 defines materiality by reference to the applicable financial reporting framework: misstatements, including omissions, are considered material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report. Materiality is not an absolute mechanical concept; it involves profound professional judgment regarding both quantitative magnitude and qualitative context.

Audit standards establish a three-tiered materiality hierarchy:

1. **Overall Planning Materiality (M):** The maximum aggregate misstatement the financial statements can tolerate before becoming materially misleading to primary users. It sets the threshold for determining the nature of the final audit opinion in the auditor's report.
2. **Performance Materiality (PM):** Set at an amount strictly lower than overall planning materiality (typically 60% to 75% of M). Its purpose is to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in individual accounts exceeds overall materiality. Performance materiality governs sample sizes and testing thresholds during field execution.
3. **Clearly Trivial Threshold (CT):** Misstatements that are wholly insignificant, both individually and in the aggregate, whether judged by size, nature, or circumstances. The auditor documents trivial items on a summary schedule without requiring managerial ledger adjustment (typically 3% to 5% of overall materiality).

3.2 Materiality Benchmarks and Determination Rules

Determining overall planning materiality involves selecting an appropriate financial benchmark and applying a professional percentage parameter based on entity characteristics:

Entity Operating Profile	Standard Financial Benchmark	Benchmark Percentage Range	Professional Rationale
For-Profit Commercial / Listed Entity	Profit Before Tax (PBT) from Continuing Operations	5.0% to 7.5% of normalized PBT	PBT is the primary metric monitored by equity investors, stock analysts, and institutional fund managers.
Commercial Entity with Volatile / Near-Zero Earnings	Total Revenue / Gross Turnover	0.5% to 1.0% of Total Revenue	When profits fluctuate wildly or hover near breakeven, revenue provides a stable measure of operational scale.
Asset-Heavy / Investment Holding / Real Estate Trusts	Total Assets or Net Asset Value (NAV)	0.5% to 1.0% of Total Assets, or 1.0% to 2.0% of Net Assets	Investors in REITs and investment entities focus on balance sheet asset valuation rather than trading margin.

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Entity Operating Profile	Standard Financial Benchmark	Benchmark Percentage Range	Professional Rationale
Not-for-Profit / Public Sector Entities	Total Gross Operating Expenditure	1.0% to 2.0% of Total Expenditure	Stakeholders focus on stewardship of allocated public funds and program delivery costs rather than profits.

3.3 Qualitative Materiality Factors

An audit finding may be quantitatively minute in dollar value yet qualitatively material if its contextual nature alters user decisions. Under ASA 320 and ASA 450, qualitative materiality triggers include:

- Misstatements that reverse an operating loss into a reported net profit, or vice versa;
- Misstatements that allow the entity to satisfy debt covenants (e.g. maintaining a current ratio $>$ 1.20), avoiding technical loan default;
- Misstatements that enable executive directors to achieve bonus and performance rights hurdle targets;
- Illegal transactions, regulatory non-compliance, or bribery under Australian foreign corrupt practices law;
- Undisclosed related-party transactions involving board members or substantial shareholders; and
- Misstatements in segment reporting that alter market perceptions regarding the profitability of core strategic business units.

3.4 Worked Numerical Example: Comprehensive Materiality Calculation Schedule

An audit engagement team plans the statutory audit of Pacific Retail Group Limited (an ASX-listed department store chain) for the financial year ended 30 June 2026. The entity's draft financial summary reports:

- Total Revenue: \$1,240,000,000
- Profit Before Tax (PBT): \$48,000,000 (after adjusting for a one-off restructuring impairment charge of \$6,000,000; normalized PBT = \$54,000,000)
- Total Assets: \$820,000,000
- Total Equity: \$360,000,000

The engagement partner determines that normalized Profit Before Tax is the most relevant benchmark for equity investors. Given that Pacific Retail is a high-profile public entity with extensive debt covenants, the partner selects a conservative percentage of 5.0%:

> $$\text{Overall Planning Materiality } (M) = 5.0\% \times \$54{,}000{,}000 = \$2{,}700{,}000$$

Because Pacific Retail has established accounting departments but experienced moderate staff turnover during the year, the partner assesses the risk of aggregated undetected errors as moderate and sets Performance Materiality at 70% of overall materiality:

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> $$\text{Performance Materiality (PM)} = 70\% \times \$2{,}700{,}000 = \$1{,}890{,}000$$

The clearly trivial threshold is set at 4.0% of overall planning materiality:

> $$\text{Clearly Trivial Threshold (CT)} = 4.0\% \times \$2{,}700{,}000 = \$108{,}000$$

Operational execution rules applied during the audit:

- Any individual or aggregated unadjusted audit misstatement exceeding \$2,700,000 that management refuses to book will result in a modified (qualified or adverse) audit opinion under ASA 705.
- Substantive sampling testing in individual accounts (e.g. inventory sampling or trade debtor confirmations) uses Performance Materiality (\$1,890,000) as tolerable misstatement.
- Any identified error exceeding \$108,000 must be formally logged on the Summary of Unadjusted Audit Differences (SUAD) and reported to the Board Audit Committee under ASA 260. Errors below \$108,000 are dismissed as trivial.

Chapter 4: The Internal Control Framework & Control Risk Evaluation

4.1 The COSO Internal Control Integrated Framework (ASA 315)

Auditors evaluate an entity's internal control system to assess Control Risk and determine the extent of reliance placed on managerial systems. ASA 315 aligns directly with the internationally recognized Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework, which organizes internal control into five integrated components across seventeen principles:

COSO Component	Underlying Principle & Meaning	Practical Control Mechanism in Practice
1. Control Environment	The "tone at the top": governance culture, ethical values, board independence, and managerial competence.	Active, independent Board Audit Committee; written code of corporate conduct; whistleblower protection hotlines.
2. Risk Assessment Process	How management identifies, analyzes, and manages operational, financial, and compliance risks.	Formal enterprise risk registers updated quarterly; regular reviews of emerging cyber and macroeconomic exposures.
3. Control Activities	Policies and procedures established to ensure management directives to mitigate risks are carried out.	Segregation of duties (authorisation, recording, custody); dual signatures; physical asset security; system password controls.
4. Information & Communication	Systems that capture and exchange information needed to conduct, manage, and control operations.	Automated ERP general ledgers; exception reporting logs; timely monthly management accounts distributed to directors.

COSO Component	Underlying Principle & Meaning	Practical Control Mechanism in Practice
5. Monitoring of Controls	Ongoing evaluations, separate evaluations, or both to ascertain whether control components are functioning.	Competent, independent internal audit function reporting directly to Audit Committee; periodic management self-assessments.

4.2 Information Technology Controls: ITGCs vs Automated Application Controls

In modern enterprises operating ERP systems (e.g. SAP S/4HANA, Oracle NetSuite, Microsoft Dynamics 365), internal controls are predominantly computerized. ASA 315 distinguishes between two tiers of IT controls:

- **Information Technology General Controls (ITGCs):** Policies and procedures that apply to all system components, processes, and data for a given organization or environment. ITGCs create the foundational infrastructure upon which automated application controls depend. ITGCs span four domains:
  1. *Access to Programs and Data:* User authentication, multi-factor authentication (MFA), role-based access permissions, segregation of duties within IT systems, and quarterly reviews of privileged super-user access rights.
  2. *Program Change Management:* Formal protocols ensuring that all source code changes, software patches, and configurations are documented, tested in a sandbox development environment, approved by business owners, and segregated from live production deployment.
  3. *Computer Operations:* Daily automated database backups, disaster recovery site replication, scheduled batch job monitoring, and cybersecurity intrusion detection.
  4. *Program Development & Implementation:* Rigorous system development lifecycle (SDLC) controls governing major new software implementations, data migration integrity checks, and user acceptance testing (UAT).
- **Automated Application Controls:** Fully automated controls embedded directly within specific software business applications that operate at the transaction level. Examples include automated three-way matching (verifying that electronic purchase orders, goods receipt notes, and vendor invoices match in quantity and price within pre-set tolerances before releasing payment); input validation checks (field type checks, range limits); and automated credit limit blockings.

Chapter 5: Fraud Risk Assessment & the Auditor's Responsibilities (ASA 240)

5.1 Distinguishing Fraud from Error and the Fraud Triangle

Under ASA 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report), the distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial report is intentional or unintentional. Fraud involves intentional deception by one or more individuals among management, governance, employees, or third parties to obtain an unjust or illegal advantage.

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Fraudulent misstatements relevant to the auditor fall into two categories: fraudulent financial reporting ("cooking the books"), and misappropriation of assets (theft or embezzlement of company property). ASA 240 adopts the sociological Fraud Triangle model formulated by Donald Cressey, which posits that three conditions are invariably present when fraud occurs:

1. **Incentive or Pressure:** Management or employees face intense pressure to achieve unrealistic financial targets, maintain stock price levels, satisfy bank loan covenants, or cover personal gambling debts.
2. **Opportunity:** Ineffective internal controls, absence of segregation of duties, complex organizational structures, or dominant senior executives create conditions where fraudulent acts can be executed without detection.
3. **Attitude or Rationalization:** Individuals possess an ethical mindset or set of moral values that allows them knowingly to commit a dishonest act, rationalizing that "everyone does it", "I am only borrowing the money until my bonus is paid", or "the company underpays me".

5.2 Mandatory Audit Presumptions and Responses to Management Override

Because management is in a unique position to perpetrate fraud due to its ability to manipulate accounting records and override controls that otherwise appear to be operating effectively, ASA 240 establishes two mandatory professional presumptions:

- **Mandatory Presumption of Fraud Risk in Revenue Recognition:** The auditor must treat revenue recognition as a significant fraud risk on every audit engagement, evaluating which types of revenue transactions, contractual milestones, or billing arrangements give rise to such risks (e.g. premature recognition of multi-year contracts, fictitious customer shipments at year-end, round-tripping sales). If the auditor concludes that the presumption is rebutted in rare circumstances, the specific justification must be documented in working papers.
- **Mandatory Procedures for Management Override of Controls:** Regardless of the auditor's assessment of the risks of management override, ASA 240 mandates that the auditor must perform three non-negotiable procedures on every audit:
    1. *Testing Journal Entries:* Using data analytics to examine the entire general ledger population for unusual, off-hours, weekend, round-number, or top-side manual journal entries posted directly to revenue or reserves by unauthorized personnel.
    2. *Reviewing Accounting Estimates for Bias:* Retrospectively reviewing prior-year management estimates (e.g. warranty provisions, allowance for doubtful debts, fair value models) against actual historical outcomes to identify systemic management optimism or intentional manipulation.
    3. *Evaluating Business Rationale for Significant Unusual Transactions:* Inspecting complex transactions that fall outside the normal course of business, especially those involving offshore tax havens, special purpose entities, or related parties, to determine whether they were engineered to misrepresent corporate financial health.

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Chapter 6: Analytical Procedures in Planning & Comprehensive Risk Response (ASA 330)

6.1 Preliminary Analytical Procedures as Risk Assessment Tools (ASA 520 & ASA 315)

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Under ASA 315, the auditor is required to apply preliminary analytical procedures during the audit planning phase to assist in understanding the business, identifying unusual transactions or events, and detecting ratios and trends that indicate potential risks of material misstatement.

Planning analytical procedures deploy three primary diagnostic methodologies:

1. **Horizontal (Trend) Analysis:** Examining percentage changes in financial report line items across multiple comparative years (e.g. FY2024 to FY2026). For instance, an auditor discovers that while total revenue expanded by 6.0%, trade accounts receivable surged by 38.0%. This sharp divergence signals aggressive credit terms, fictitious billing near year-end, or an inadequate allowance for expected credit losses under AASB 9.
2. **Vertical (Common-Size) Analysis:** Converting every line item into a percentage of a core aggregate—total assets for balance sheet items, and total revenue for income statement items. If gross profit margin jumps unexpectedly from 28.0% to 35.5% during an industry-wide raw material cost surge, the auditor identifies a heightened risk of unrecorded inventory purchases or overstated closing stock.
3. **Ratio Analysis:** Computing financial ratios across four fundamental operational dimensions:
   - *Liquidity Ratios:* Current Ratio $(\text{Current Assets}/\text{Current Liabilities})$ and Quick Ratio $((\text{Cash} + \text{Receivables})/\text{Current Liabilities})$. Deteriorating liquidity signals impending debt covenant default or going concern stress (ASA 570).
   - *Solvency & Gearing Ratios:* Debt-to-Equity Ratio $(\text{Total Debt}/\text{Total Equity})$ and Interest Coverage Ratio $(\text{EBIT}/\text{Finance Costs})$. A declining interest coverage ratio increases managerial incentive to fabricate revenue to prevent bank intervention.
   - *Activity / Turnover Ratios:* Days Sales Outstanding ($\text{DSO} = (\text{Accounts Receivable}/\text{Credit Sales}) \times 365$) and Days Sales in Inventory ($\text{DSI} = (\text{Ending Inventory}/\text{Cost of Sales}) \times 365$). A dramatic elongation in DSI points to obsolete, damaged, or slow-moving stock requiring net realizable value write-downs under AASB 102.
   - *Profitability Ratios:* Gross Margin $(\text{Gross Profit}/\text{Revenue})$, Operating Margin $(\text{EBIT}/\text{Revenue})$, and Return on Assets $(\text{Net Profit}/\text{Total Assets})$.

6.2 Worked Numerical Example: Preliminary Analytical Diagnostic on an Australian Retailer

An audit team analyzes comparative financial data for Australian Home Retailers Limited during audit planning:

Financial Metric	FY2025 (Audited)	FY2026 (Draft)	Dollar Change	Percentage Change
Revenue	\$450,000,000	\$486,000,000	+\$36,000,000	+8.0%
Cost of Goods Sold (COGS)	\$315,000,000	\$320,760,000	+\$5,760,000	+1.8%
Gross Profit	\$135,000,000	\$165,240,000	+\$30,240,000	+22.4%
Ending Inventory	\$52,000,000	\$78,000,000	+\$26,000,000	+50.0%
Trade Accounts Receivable	\$38,000,000	\$62,000,000	+\$24,000,000	+63.2%

Key diagnostic ratio calculations:

1. **Gross Profit Margin:**

$$\text{Margin}_{\text{FY25}} = \frac{\$135{,}000{,}000}{\$450{,}000{,}000} = 30.00\%, \qquad \text{Margin}_{\text{FY26}} = \frac{\$165{,}240{,}000}{\$486{,}000{,}000} = 34.00\%$$

   An increase of 400 basis points in gross margin is highly abnormal given industry cost inflation of 4.5%.

2. **Days Sales in Inventory (DSI):**

$$\text{DSI}_{\text{FY25}} = \frac{\$52{,}000{,}000}{\$315{,}000{,}000} \times 365 = 60.25 \text{ days}$$

$$\text{DSI}_{\text{FY26}} = \frac{\$78{,}000{,}000}{\$320{,}760{,}000} \times 365 = 88.76 \text{ days}$$

   Inventory holding duration increased by 28.5 days ($+47.3\%$), indicating slow-moving lines or inflated inventory valuation.

3. **Days Sales Outstanding (DSO):**

$$\text{DSO}_{\text{FY25}} = \frac{\$38{,}000{,}000}{\$450{,}000{,}000} \times 365 = 30.82 \text{ days}$$

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$$\text{DSO}_{\text{FY26}} = \frac{\$62{,}000{,}000}{\$486{,}000{,}000} \times 365 = 46.56 \text{ days}$$

Collection duration lengthened by 15.7 days ($+51.1\%$), indicating uncollectible customer balances or fictitious billing.

Audit Planning Implication: The auditor assesses heightened Inherent Risk and significant fraud risk for Inventory Valuation (Existence and Valuation assertions) and Accounts Receivable / Revenue (Occurrence and Cut-off assertions). Detection risk must be set to Low, requiring physical inventory observation across all major distribution centres and independent external accounts receivable confirmations.

6.3 Overall Responses vs Assertion-Level Responses under ASA 330

Under ASA 330 (The Auditor's Responses to Assessed Risks), the auditor designs responses addressing risks at two distinct operational tiers:

- **Overall Responses to Financial Report Level Risks:** Address pervasive risks that affect multiple assertions across the entire financial report (e.g. a deficient control environment or dominant CEO). Overall responses include:
  - Assigning more experienced audit staff and specialized forensic experts;
  - Providing closer supervision and more frequent on-site manager reviews;
  - Incorporating elements of unpredictability in the selection of audit procedures (e.g. testing unannounced warehouse locations, selecting balances below standard sampling thresholds); and
  - Maintaining heightened professional scepticism across all evidence evaluations.
- **Assertion-Level Audit Responses:** Targeting specific account balances and transaction cycles through the calibration of three parameters:
  1. *Nature:* The purpose (Tests of Controls vs Substantive Testing) and type (inspection, observation, external confirmation, recalculation) of procedure. High RMM requires external, documentary, corroborative evidence.
  2. *Timing:* Performing procedures at year-end or post-balance date rather than interim dates to minimize roll-forward uncertainty.
  3. *Extent:* Increasing sample sizes or deploying automated data analytics to test 100% of transaction populations.

Chapter 7: The Overall Audit Strategy, Audit Plan & Governance Communications

7.1 Formulating the Overall Audit Strategy (ASA 300)

The formulation of the overall audit strategy sets the scope, timing, and direction of the audit, guiding the development of the more detailed audit plan. Under ASA 300, the engagement partner and key team members establish the strategy by considering five core factors:

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1. **Characteristics of the Engagement:** The financial reporting framework (AASB/IFRS), industry-specific reporting requirements (e.g. APRA prudential standards for financial institutions), multi-location operations across Australian states, and the need for specialized IT auditors or valuation experts.
2. **Reporting Objectives, Timing & Communications:** Deadlines for preliminary announcements under ASX Listing Rule 4.3A (Appendix 4E Preliminary Final Report), statutory lodgement of audited annual reports under s. 319 of the Corporations Act 2001 (within three months of financial year-end for public disclosing entities), and scheduled meetings with the Board Audit Committee.
3. **Significant Factors, Preliminary Activities & Knowledge:** Preliminary materiality thresholds, results of client continuance reviews, findings from prior-year audits, and recent organizational changes (such as new cloud ERP implementations or senior executive turnover).
4. **Nature, Timing & Extent of Resources:** Selection of engagement team personnel with appropriate industry experience, deployment of data analytics specialists, and scheduling interim testing visits (typically undertaken during Months 9–10 of the financial year).
5. **Substantive vs Combined Approach Selection:** Deciding for each core transaction cycle whether to test and rely upon internal controls (Combined Approach) or rely entirely on detailed substantive testing (Substantive Approach).

7.2 Comparative Decision Matrix: Combined Approach vs Substantive Approach

Operational Dimension	Combined Audit Strategy (Reliance on Controls)	Purely Substantive Audit Strategy (No Control Reliance)
Core Operating Premise	Internal controls are evaluated as well-designed and expected to operate effectively throughout the reporting period.	Internal controls are either assessed as deficient / non-existent, or testing them is economically inefficient.
Assessed Control Risk (CR)	Assessed as Low to Moderate ($CR \leq 0.40$).	Assessed at Maximum ($CR = 1.00$).
Mandatory Testing Requirements	Must perform formal Tests of Controls (ToC) to obtain audit evidence that controls operated effectively at all relevant times.	No Tests of Controls performed; testing consists solely of substantive analytical procedures and tests of details.
Planned Detection Risk (DR)	Can be set to Moderate or High, permitting reduced substantive testing at year-end.	Must be set to Low or Very Low, requiring extensive substantive evidence at year-end.
Standard Application	Routine, high-volume, automated transaction cycles (e.g. retail cash sales, utility billing, recurring payroll).	Non-routine, highly subjective, low-volume, or year-end balance sheet valuations (e.g. goodwill impairment, litigation provisions).

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7.3 Mandatory Governance Communications (ASA 260 & ASA 265)

Auditing standards enforce continuous two-way communication between the independent auditor and those charged with governance (primarily the Board Audit Committee):

- **Communication of the Audit Plan (ASA 260):** The auditor communicates an overview of the planned scope and timing of the audit, including discussions of significant risks identified, overall materiality parameters, and the extent of reliance on internal audit or external experts. However, the auditor avoids compromising audit effectiveness by not disclosing specific sample sizes or individual testing thresholds.
- **Reporting Significant Deficiencies in Internal Control (ASA 265):** If the auditor identifies deficiencies in internal control that, in the auditor's professional judgment, are of sufficient importance to merit the attention of governance, the auditor must communicate them in writing on a timely basis through a formal Management Letter. The communication details the nature of each deficiency, explains its potential financial misstatement consequences, and provides actionable recommendations for remedial control design.

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