



Why Audit Matters and Sharing Understanding in Audit Communication to Form Insights - 2

In our Notes of 26 January 2015, we suggest that companies should discuss with their auditors about the scope and format of audit communication so that value adding insights can be shared. While auditing standards encourage effective two-way communication in matters concerning significant audit findings and deficiencies in internal control, what should be on the agenda would depend on issues arising from particular situations. One may look to the International and Hong Kong Standard on Auditing 315 that provides a useful general frame of reference.

ISA / HKSA 315

ISA / HKSA 315 deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding of the entity and its environment, including the entity's internal control. It requires the auditor to look at 3 essential aspects to obtain the required understanding of an entity: (1) the entity and its environment, (2) the nature of the entity, and (3) the entity's internal control. The standard provides layers of pointers on how to go about a business analysis in order to form a view on the entity and anticipate what the entity's financial statements should tell about its transactions, balances and disclosures. We now fit the pointers into the commercial process of a business, as diagrammed in our previous Notes.

Direction and strategies

The board or those in charge of governance decide on matters concerning the orientation of a company and set strategies for steering it towards desirable positions, avoiding dangers. The board or its management must do so amidst constant changes as no business can grow or survive for long by staying on the same course. It is important to assess if a company is ready for and responsive to changes in its operating environment.

ISA / HKSA 315 requires auditors to understand a company's environment by obtaining information about its industry and regulatory changes, such as, industry conditions, supplier-customer relationships, technological developments, the cost structure of crucial inputs, pricing of products, market competition and demand capacity. It also requires an understanding of changes in other external factors such as, general economic conditions, monetary and fiscal measures, inflation and currency fluctuations.

With an understanding of the context in which a company is operated, the standard requires the auditor to learn about the company's objectives and strategies and assess the audit implications of the related business risks. The company may therefore derive insights into whether it has a full appreciation of its dynamic capabilities by exchanging observations with its auditor in this respect.

Business model and value chain

A company must exist for a purpose, have a viable structure and organization, to be able to source and convert inputs into value added outputs that the market needs, in order to generate sufficient revenue and be efficient enough to make a surplus over costs. The company's business model and value chain must continue to evolve in full alignment with its changing orientation and environment.

ISA / HKSA 315 requires auditors to understand a company's operations and structure, the market and industry segments, the locations in which it operates, key customers and suppliers, important alliances, revenue sources, products and services, stages and methods of production, transactional cycles, research and innovation capabilities, investments and corresponding legal and financing structures, etc.

By exchanging observations with its auditor in this respect, a company may derive insights into whether it can improve its business model and whether its value can be further optimized.

Resource allocation and budget

Surviving the competition in business is a serious challenge and only those who can plan, manage and control well may have a decent chance of success. Budgeting is a crucial tool for disciplined planning and control, for allocation of precious resources, for measuring performance, for locating errors and taking corrective actions. It is a tool for learning and improving against standards and benchmarks.

ISA / HKSA 315 requires auditors to understand what a company's management regards as important, how objectives are set, controls monitored, results measured and improvement actions taken. Auditors may do so by looking at the working of budgets and other tools such as key performance indicators, key performance ratios, trends, operating statistics, change analysis, segment information, divisional reports, incentive policies and benchmarking against competitors or comparables.

A company may discuss with its auditor on how it may improve its capability of planning and control by using better budgets and other related tools, which can also enable it to learn and improve over time.

Production and operating system

Business entities can be viewed as a system converting inputs into valuable outputs. The system spans all the business functions that typically include marketing and sales, technical and research, sourcing and warehousing, production and delivery, settlement and accounting. These functions are core activities that together determine a company's core competence and competitive advantages.

ISA/ HKSA 315 requires auditors to inspect a company's operation and its facilities, make observations, undertake analytical reviews, inquiring into a company's strategic positioning, performance, liquidity and longer term stability issues.

While inspection and observation may reveal the condition of facilities and assets, discipline of workforce, method of organization, and the conduct of production and related processes, an analytical review must also be performed for a deeper understanding of where a company stands vis-à-vis competition in the industry, how its path was formed and evolved, what its core assets are, where it is trending into the future, whether it is adjusting to form new advantages, and importantly, how it is

performing overall and in all different aspects of its operation. These are areas where a company and its auditor should share observations to form useful insights.