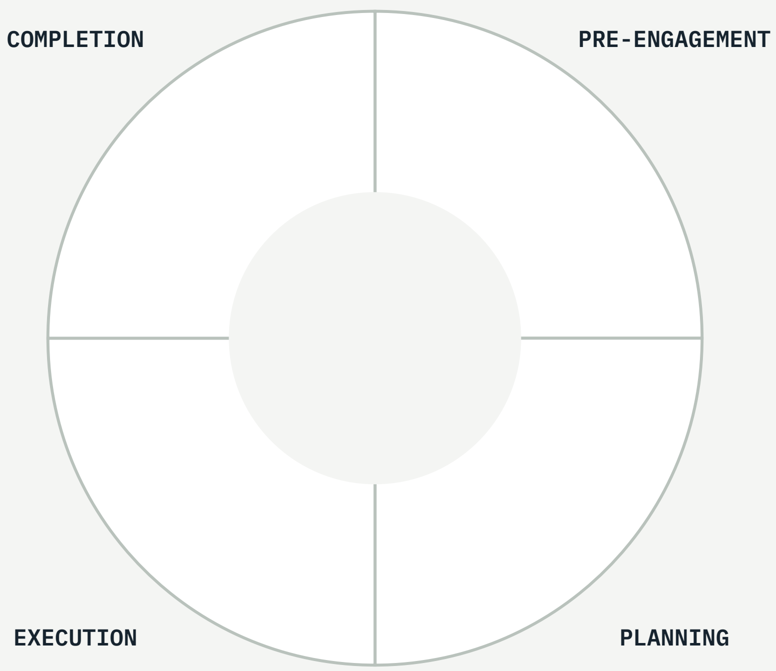
LGC FOUNDATION / AUDIT FRAMEWORK GUIDE

# Think Like an Auditor

A framework for the audit cycle, worked through IFRS 15 Revenue

For 2nd & 3rd Year Audit Students · CA(SA) / ACCA / CIMA

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00 — BEFORE YOU BEGIN

# Your North Star

Every question in this guide, and every question you'll face in the exam hall, is in service of one idea. Read it once. Carry it through everything that follows.

> A student who understands audit can articulate that a line item is free from material misstatement, because the procedures performed have reduced the risk of material misstatement to an acceptable level — tested against performance materiality, supported by sufficient appropriate evidence.

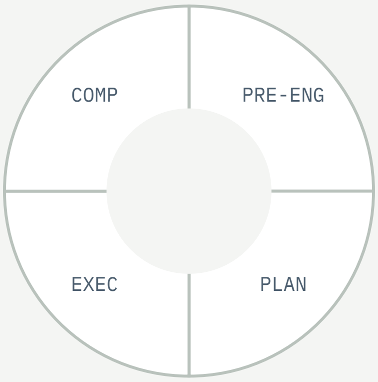
This guide will not re-teach what your university already covers. It will not define every term in the syllabus. It exists for one purpose: to give you a framework for thinking your way through an audit question you haven't seen before — using Revenue under IFRS 15 as the single worked example you'll carry through every phase.

This resource sits alongside your university studies, not instead of them. Definitions, standards in full, and syllabus coverage are your lecturer's job. This is the thinking layer on top.

00 — BEFORE YOU BEGIN

# The Audit Cycle

Every audit moves through four phases, in this order. Before you answer any question, ask yourself: which phase am I in, and what is this phase trying to achieve?




| | |
|---|---|
| PRE-ENGAGEMENT | Decide whether to accept or continue the client relationship. Assess independence, integrity, and competence before any audit work begins. |
| PLANNING | Understand the entity, set materiality, identify risks of material misstatement, and design the overall audit strategy. |
| EXECUTION | Perform procedures that respond directly to the risks identified in planning. This is where item-level questions live. |
| COMPLETION | Step back: review going concern, subsequent events, and overall evidence, then form the audit opinion. |

00 — BEFORE YOU BEGIN

# Meet the Company

One simple company, carried through every phase of this guide. Karabo Manufacturing (Pty) Ltd manufactures industrial cleaning equipment and sells to hardware retailers across South Africa. Financial year end: 28 February. This is a continuing audit engagement.

## Statement of Comprehensive Income (extract)

| Line Item | R |
|---|---|
| Revenue | 42 600 000 |
| Cost of Sales | (28 900 000) |
| Gross Profit | 13 700 000 |
| Profit Before Tax | 9 800 000 |

## Statement of Financial Position (extract)

| Line Item | R |
|---|---|
| Property, Plant & Equipment | 18 400 000 |
| Inventory | 5 100 000 |
| Trade Receivables | 6 200 000 |

These are illustrative extracts, not full financial statements. Enough detail to work through the framework, no more.

01 — PRE-ENGAGEMENT

# Before Any Fieldwork Begins

Before an auditor tests a single number, the firm has to decide whether it should be doing this audit at all. This phase is about the firm and the relationship, not yet about Karabo's financial statements.

**1** Client acceptance or continuance

For a continuing engagement like Karabo, reconfirm nothing has changed that would affect the decision to continue: no new integrity concerns about management, no change in the firm's ability to serve the client properly.

**2** Independence and ethical requirements

Confirm the firm and engagement team remain independent of Karabo, and that the team has the competence, capacity, and resources to perform the audit.

**3** Preconditions for an audit

Confirm an acceptable financial reporting framework is being used (IFRS, in Karabo's case) and obtain management's agreement that they understand their responsibility for the financial statements and for providing the auditor access to information.

**4** Engagement letter

Agree the terms of the engagement in writing: scope, responsibilities of each party, and the applicable reporting framework, before fieldwork begins.

**WHY THIS PHASE MATTERS**

Skipping this phase doesn't just create risk for the client. It creates risk for the audit firm. Every phase that follows assumes this one was done properly.

02 — PLANNING

# Setting Materiality & Identifying Risk

Planning is where the auditor decides what “material” actually means in rand terms for this specific engagement, and forms an initial view of where things could go wrong.

## Step 1: Understand the Entity

Karabo manufactures and sells industrial cleaning equipment to retail hardware stores. Revenue is a key driver of the business and a metric management is evaluated on, which is relevant later when assessing risk.

## Step 2: Determine Materiality

ISA 320 requires the benchmark to be substantiated, not assumed. Profit before tax is common for profit-oriented entities, but it isn't automatic. For Karabo, revenue is the more defensible choice: profit moves with production costs and can be volatile year to year, while revenue is the more stable figure, and it's the same metric flagged in Step 3 as the one management is evaluated on. Anchoring materiality to revenue keeps the threshold aligned with where the real pressure in this engagement sits.

| Basis | Calculation | Amount (R) |
|---|---|---|
| Materiality | 1% of Revenue | 426 000 |
| Performance Materiality | 75% of Materiality | 319 500 |
| Clearly Trivial Threshold | 5% of Materiality | 21 300 |

1% sits within the typical 0.5%–1% of revenue range used for a revenue-based benchmark, appropriate for an established, continuing client like Karabo with no history of significant misstatement.

Performance materiality is set below materiality on purpose: it builds in a margin of safety so that small, undetected misstatements don't quietly add up past the real materiality threshold.

## Step 3: Perform a Walkthrough

A walkthrough traces one transaction through the revenue process from initiation to recording in the financial statements, confirming your understanding of the controls at each point along the way. For Karabo: follow a single sale from the customer's order, through credit approval, dispatch, invoicing, and finally recording in the general ledger.

A walkthrough does two things. It confirms controls are properly designed and actually implemented, not just documented on paper. And it tells you how to approach testing: whether you can rely on controls and test them directly, whether you need a fully substantive approach, or some combination of both.

This same technique applies to any process you're asked about, not only revenue: purchases and payables, wages and salaries, inventory. One transaction, traced start to finish, is how you build real understanding of a process, whichever one it is.

### Step 4: Identify Risk at the Financial Statement Level

ISA 315 (Revised) is the standard that governs this step, and it requires more than a gut feeling that something is risky. What the walkthrough just showed you about Karabo's controls feeds directly into this. Revenue is flagged as a significant risk area, substantiated by two inherent risk factors the standard names explicitly: it's the metric management is evaluated on (susceptibility to management bias), and it's the largest, most transaction-heavy line on the income statement (complexity). This is a preliminary flag. It gets refined into specific risks, and named inherent risk factors, once we reach Execution.

Two further risks don't need to be found at all: ISA 240 presumes them on every audit, regardless of what you observe. Fraud in revenue recognition is a rebuttable presumption specific to revenue. Management override of controls is presumed for the engagement as a whole, since management is always positioned to override the very controls that were walked through above. Both require specific procedures beyond whatever entity-specific risks you identify.

**WHERE THIS IS GOING**

Notice Planning doesn't yet ask “what procedures do we perform on revenue?” That question belongs to Execution. Planning only decides that revenue deserves closer attention.

03 — EXECUTION

# The Item-Level Framework

Every item, on any exam paper, can be approached with the same six questions. This is the pattern you'll apply to Revenue on the following pages, and the same pattern you'll transfer to every other line item you're asked about.

1. What is this item?
   Understand what you're actually looking at before anything else.
2. Is there a relevant IFRS?
   Identify the standard that governs recognition, measurement, presentation, and disclosure.
3. What assertions are being tested?
   Existence, completeness, accuracy, valuation, rights & obligations, presentation & disclosure.
4. What risks can I identify?
   ISA 315 (Revised): name the inherent risk factor driving it — complexity, subjectivity, change, uncertainty, or susceptibility to bias or fraud.
5. What general procedures apply?
   The easy marks: procedures that apply to almost any item, performed first.
6. What specific procedures respond to the risk?
   Only once the general ground is covered do you design procedures for the specific risk you identified.

03 — EXECUTION

# Revenue: What & Which Standard

## Question 1: What Is This Item?

Revenue from the sale of cleaning equipment to retail hardware customers. Karabo has one type of contract and one performance obligation per sale: deliver the equipment. Understanding this early matters, because it tells you exactly when revenue should be recognised: on delivery, when control of the goods transfers to the customer.

## Question 2: Is There a Relevant IFRS?

IFRS 15, Revenue from Contracts with Customers, governs this item. Its five-step model is the lens you apply to any revenue question, not just Karabo's.

1. **Identify the contract with a customer**
   A sale order or contract exists between Karabo and the retailer.
2. **Identify the performance obligations**
   One obligation here: deliver the cleaning equipment.
3. **Determine the transaction price**
   The agreed invoice price for the goods sold.
4. **Allocate the transaction price**
   Straightforward with a single obligation: the full price applies to the one obligation.
5. **Recognise revenue when/as the obligation is satisfied**
   At the point in time control transfers to the customer, typically on delivery.

03 — EXECUTION

# Revenue: Assertions & Risks

### Question 3: What Assertions Are Being Tested?

Revenue is an income statement item, so two assertions carry the most weight: occurrence (did the sale actually happen?) and cut-off (was it recorded in the right period?). Completeness, accuracy, classification and presentation still matter, but occurrence and cut-off are where revenue misstatements most often hide.

### Question 4: What Risks Can I Identify?

ISA 315 (Revised) asks for more than a hunch. Each risk below is substantiated with the specific inherent risk factor driving it, the vocabulary the standard uses to document why an item is risky, not just that it is.

**A** Cut-off risk
Goods may be invoiced before dispatch, or dispatched after year end but recorded in the current year, inflating revenue in the period under audit. Inherent risk factor: complexity, since determining the exact point control transfers requires judgement about shipping terms.

**B** Occurrence / overstatement risk
Pressure to meet targets creates an incentive to record sales that didn't occur, or to overstate the amount recorded, particularly close to 28 February. Inherent risk factor: susceptibility to misstatement due to management bias or fraud.

**C** Presumed fraud risk in revenue recognition
ISA 240 creates a rebuttable presumption that revenue recognition carries a fraud risk, on every audit, regardless of what you've observed about Karabo specifically. This isn't found through analysis. It's assumed unless the auditor documents a specific reason to conclude otherwise.

**NOTICE THE PATTERN**

Risks A and B were found by understanding Karabo specifically: its business, its controls, its pressures. Risk C wasn't found at all, it's presumed by the standard on every revenue engagement, even one as clean-looking as Karabo's. Both kinds of risk require a response.

03 — EXECUTION

# Revenue: Procedures

## Question 5: What General Procedures Apply?

Perform these regardless of what specific risks you've identified. They're the easy marks, and they also often surface issues that inform the specific procedures that follow.

1. **Cast and agree**
   Obtain the revenue schedule from the general ledger, cast it, and agree the total to the trial balance and financial statements.
2. **Analytical review**
   Compare current year revenue to prior year and budget. Investigate any fluctuation that doesn't have an obvious explanation.
3. **Accounting policy check**
   Confirm Karabo's stated revenue recognition policy is consistent with IFRS 15 and was applied consistently with the prior year.

## Question 6: What Specific Procedures Respond to the Risk?

Only now, once the general ground is covered, do we design procedures aimed at the risks identified in Question 4, whether found through analysis or presumed by the standard. Each procedure below exists because of a specific risk, not the other way around.

| Risk | Responding procedure |
|---|---|
| **RISK 1**<br>Cut-off risk<br>Revenue recorded in the wrong period around year end. | **RESPONDING PROCEDURE**<br>Sample testing around year end<br>Select a sample of sales recorded in the last two weeks before, and first two weeks after, year end. Trace each to the dispatch note and shipping terms to confirm the period control actually transferred. |
| **RISK 2**<br>Occurrence / overstatement risk<br>Sales recorded that didn't happen, or recorded at the wrong amount. | **RESPONDING PROCEDURE**<br>Vouching to supporting documentation<br>Select a sample of revenue transactions recorded during the year. Trace each to the sales order, dispatch note, invoice, and proof of delivery to confirm the sale occurred and was recorded correctly. |
| **RISK 3**<br>Presumed fraud risk (ISA 240)<br>A standing risk on every revenue engagement, not something found through analysis of Karabo. | **RESPONDING PROCEDURE**<br>Unpredictability and journal entry testing<br>Build an element of unpredictability into testing, such as varying which period or sample is selected from prior years. Specifically test manual journal entries posted to revenue for unusual account combinations, timing, or amounts. |

**CLOSING THE LOOP**

Each procedure above responds directly to a named risk, whether that risk was found through understanding Karabo or presumed by the standard itself. This is what reducing the risk of material misstatement to an acceptable level actually looks like in practice, not just as a phrase you memorise.

04 — COMPLETION

# Finishing the Engagement

Completion is administrative and reflective, not a return to testing individual items in detail. Your university covers this depth well; here's the shape of it.

1. **Overall review of the financial statements**
   Step back from individual items and consider the financial statements as a whole: internal consistency, and whether required disclosures are complete.

2. **Subsequent events review**
   Consider events between year end and the date of the audit report that might require adjustment or disclosure.

3. **Going concern assessment**
   Evaluate whether the entity remains able to continue operating for the foreseeable future.

4. **Evaluate uncorrected misstatements**
   Assess identified misstatements, individually and in aggregate, against materiality.

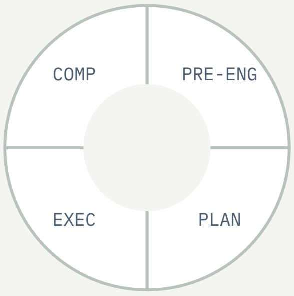
5. **Written representations**
   Obtain a signed letter from management confirming responsibility for the financial statements and disclosure of all relevant information.

6. **Form the audit opinion**
   Conclude whether sufficient appropriate evidence was obtained across the engagement, and issue an unmodified or modified opinion accordingly.

QUICK REFERENCE

# The Whole Framework, One Page

## The Cycle




## The Six Questions (Execution)

1. What is this item?
2. Is there a relevant IFRS?
3. What assertions are being tested?
4. What risks can I identify?
5. What general procedures apply?
6. What specific procedures respond to the risk?

Don't forget: ISA 240 presumes fraud risk in revenue recognition and management override of controls on every audit, regardless of what you observe about the entity.

## The North Star

Free from material misstatement. Risk reduced to an acceptable level. Tested against performance materiality. Supported by sufficient appropriate evidence.

CLOSING NOTE

# Carry This Into Every Question

This guide will not make audit easy. Nothing will. What it should do is give you a place to start when a question doesn't look like anything you've memorised: which phase am I in, what is this item, and what does the North Star require of me here.



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