The Audit Acceptance and Planning Process - July 2016

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The audit acceptance and planning process can be compared to a road map which gives directions and guidance for the audit team to follow throughout the audit in order to help it reach the correct final conclusion, i.e. whether the financial statements give a true and fair view of the position of the company at the end of the accounting period.

The issues and activities that an auditor must consider prior to commencement of the fieldwork of an audit are of vital importance. These are referred to as the audit acceptance and planning stages. Identification of these various stages will assist the auditor to recognise key areas of risk and concerns, which in turn will help the auditor make decisions such as:

- whether to accept or continue an engagement
- what level of audit staff is required to carry out the audit
- whether outside experts will be needed; and
- the nature, timing and extent of the work to be done.

The process of audit acceptance, planning and subsequent undertaking and completion of the audit can be broadly distilled into four phases, namely;

- Phase 1: Acceptance of the audit
- Phase 2: Planning the audit
- Phase 3: Documenting audit plan and strategy, performing the audit and gathering audit evidence
- Phase 4: Completing the audit and issuing an audit opinion on the financial statements.

Phase 3, documenting the plan and strategy of the audit, the gathering of audit evidence via the performance of the audit process will vary from audit to audit. The methods for gathering the evidence are dependent on the nature of the entity's business, the internal controls and the transactions and balances included within the financial statements.

Phase 2 is critical to the success of Phases 3 and 4. This is because if not adequately planned or an inappropriate strategy is adopted the approach to performing the audit and gathering evidence may not be suitable, resulting in sufficient evidence not being obtained by the audit team, and an incorrect audit opinion being issued

Review of Phases 1 and 2.

Phase 1: Acceptance of the audit

Audit firms should only accept a new client or continue an existing client relationship where it;

- Has considered the integrity of the client
- Is competent to perform the engagement (capabilities / time / resources)
- Is in compliance with Ethical Standards for Auditors

ISA 220 – Quality Control for Audits of Financial Statements
Audit firms should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements.
These should be designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the three principles listed above are met.

The key point is that an audit firm does not want to engage with a client who brings with it unacceptable levels of risk; thus it is essential that a thorough assessment is made of the prospective engagement prior to the firm becoming engaged with the client.

Issues to be considered in relation to integrity, competency and ethics that the auditor may have cause to address, are various. A sample of such issues are outlined below:

Integrity of the Client:

- Client Reputation
- Nature of Client Operations
- Attitudes of Key Players (Aggressive Standards Interpretation / internal controls / Low audit fees / limiting scope of work)
- Money Laundering
- Outgoing auditors (reason).

Competency of the Audit Firm to Perform the Engagement:

- Knowledge of Industry / Subject Matter
- Experience with Relevant Statutory / Reporting Requirements
- Sufficient Personnel and Time / Capacity
- Experts where Necessary

Ethical Considerations:

- Ability to Perform Quality Control Review.
- Audit Firm and Individual Personnel - Independence
- No perceived Conflict of Interest with an existing audit client.

Where issues arise out of any of the above considerations, the firm must conduct appropriate consultations with the client or third parties. Should the firm then decide to engage with the client. It must ensure that a record of the resolution of the issues involved is documented clearly in the audit file.

In the event that no such issues are raised in regards to the client the firm may issue the engagement letter.

The final decision as to whether to engage with a new client or continue engaging with an existing client is the responsibility of the audit engagement leader:

- “The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate”

ISA 220 – Quality Control for Audits of Financial Statements Paragraph 12

Issue of an engagement letter

The auditor and the client should agree terms of the engagement and the terms should be recorded in writing.
The issuing of an engagement letter is in the interest of both the firm and the client, as it helps avoid any misunderstandings with respect to the engagement.
The client and the auditor should agree on all terms of the engagement and the signing of the engagement letter is the recognition of this agreement.
The following main points of reference should be included in an engagement letter:

- The objective and scope of the audit of the financial statements
- The responsibilities of the auditor
- The responsibilities of the management
- Identification of the applicable financial reporting framework for the preparation of the financial statements
- Reference to an expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

A new engagement letter may not be required each year of a continuing engagement. However, each year the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement. Alternatively, the client may request a change to the terms of the engagement.

Phase 2: Planning the audit

Importance of planning.

“..the auditor should plan an audit so that the engagement will be performed in an effective manner and reduce audit risk to an acceptably low level”

ISA 300 – Planning an Audit of Financial Statements

The auditor may approach the process by identifying two main areas of planning namely;

- Establish the overall Audit Strategy
- Develop an Audit Plan

This part of the procedure is performed in conjunction with all members / levels of the audit team and with their experience and competencies in mind

Audit Strategy

There must be consideration of a number of key factors in order to ensure the detailed plan is the most efficient approach and hence assists in guiding the detailed audit plan. Some key factors include:

- Assessment of the internal control function within the entity
- Resourcing the audit
- Determination of audit materiality
- The concept of risk, and the assessment of risk of material misstatement and developing responses to risks at financial statement and assertion levels.

Adequate audit planning should benefit an audit of financial statements in a number of facets, some of which are listed below:

- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, where applicable, in coordination of work done by experts
- Helping the auditor to devote appropriate attention to important areas of the audit
- Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner
- Helping the auditor identify and resolve potential problems on a timely basis.

The auditor must develop an understanding of internal control function within the entity (see ISA 315) by considering the following factors:

Tone at the top

- Participation by those charged with governance
- Management philosophy and operating style
- Communication and enforcement of integrity and ethical values.

Organisational Structure

- Chart of authority (assignment of authority and responsibility)

Human Resource

- HR Policies and Practices
- Commitment to competence.

Materiality (see ISA 320)

When determining audit materiality the auditor must consider:

- Misstatements (omissions) are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of the users.
- Judgements about materiality should be taken in light of surroundings – size v nature of misstatement.
- Materiality is a matter of audit judgement taking into account auditor perception of financial information needs of the user.

Materiality discussions points:

- Performance materiality – lower than materiality for financial statements as a whole.
- Relativity to financial statements.
- Overall Materiality level for financial statements as a whole – v – materiality for particular classes of transactions.
- Possible existence of undetected and material misstatements.
- Calculating materiality – identify Financial Statement critical balance (i.e. profit / net assets / revenues etc)

  Profits – 5% / Net Assets - 0.5% / Revenues 0.5%
- Updating Materiality

Sample Question

You are planning the audit of Lonco Ltd (Lonco) for the year ended 31 December 20X5. The company manufactures and sells products made from imported timber.
In recent years, the company has expanded into the manufacture of quality childrens' garden swings and jungle gyms which are sold with a 10-year guarantee. Most sales are to domestic customers, but the company also has a small export market which has grown steadily over the last few years.
At your planning meeting with the finance director, the following matters were discussed:

Operating activities
During the year, the company's revenue increased by 20% and the gross and operating margins increased by 5% and 2% respectively. Inventory and trade receivable balances are significantly higher than the previous year as a result of this increased activity.
Online ordering on the company's website began in recent years. Internet orders have grown steadily but still only represent a small percentage of the total of company sales however the company continues to invest significant sums in the website to maintain its speed and ease of use for customers.

Payroll
Following the successful implementation of a new computer system two years ago, payroll processing, which had been outsourced for many years, was brought back in house from 1 March 2013. Management were unhappy with the service provided by the external payroll company, and cancelled the contract. Additional staff has been recruited to process the payroll.

Managing director
The MD has announced his intention to sell his 100% shareholding in Lonco in order to concentrate on his other business interests. Negotiations are underway with a potential buyer for his shares.

Requirement:
From the information provide above assess how it will affect the strategy and planning of the audit in regards to the audit risks and recommend appropriate audit procedures in response to each risk.

Sample Answer

Risk	Example Procedures
Purchase invoices from imports are likely to be in foreign currencies (unlikely but possible for export sales). This increases the risk of incorrect translation of foreign amounts into the home currency. There is a risk of misstatement of purchases and payables (and possibly of sales and receivables).	For a sample of purchases agree the exchange rate applied to an external source (such as the Irish Times) to confirm the accuracy of the retranslation. Confirm software capable of dealing with exchange rates by testing a sample of rates used in the system to externally gathered exchange rates. Enquire of directors how they (or the accounting system) identify the correct daily translation rate. For a sample of material payables balances re-translate the amount owed at 31 December 20X5 with the translation rate on that day to ensure all outstanding amounts are translated to current amounts.
All play equipment sold with a 10-year warranty. Directors will need to estimate the potential repair costs for faulty goods sold within the last 10 years, which may be difficult to do accurately. There is a risk of misstatement of the provision for warranty costs.	Enquire of directors how they have estimated the provision and re-perform the calculation. Compare the provision to a mixture of forecasts and post year-end correspondence from claimants to assess whether the current provision is adequate to cover estimated returns. Compare previous years' provisions to the level of actual returns received in the following years to identify the accuracy of previous estimates.
The increase in revenue coupled with gross profit margin may not on its own give rise to suspicion. However, the MD/100% shareholder selling his shares provides a significant reason to want to manipulate annual profits so that he can achieve the maximum possible gain from the share sale. There is a risk of misstatement of annual revenue/profit in 20X5.	Analytically review sales lines across the whole garden furniture line. Obtain appropriate explanations for significant rises in sales by product. Re-perform cut-off procedures for goods despatched just prior to and just after the year-end. Trace them to the sales ledger to confirm they are recorded in the correct period. Review a sample of credit notes raised shortly after the year-end to identify the completeness of any provisions against annual sales.
Lonco continues to invest in the website to improve its ease of use. Subsequent repair costs should by expensed. Only those costs that	Analytically review repairs and maintenance costs to identify any unusual changes in expenses trends.

increase the benefit of the noncurrent assets may be capitalised There is a risk of misstatement of website maintenance costs.	Inspect breakdown of additions to noncurrent assets to identify any amounts which should be expensed as repair costs. Inspect a sample of invoices relating to system costs to identify if they relate to system improvements or repair/maintenance costs.
The new payroll system has only been operational for 9 months and the staff who administer it are also new. The system may be prone to 'teething' problems due to a developing control environment. There is a risk of misstatement of payroll costs and related liabilities.	Document the payroll system, highlighting the controls that operate. Test the operation of the system and controls using walkthrough procedures. Test a sample of monthly payroll totals by comparing amounts entered into the system to original documents, such as salary contracts and timesheets. Confirm year-end wage/ salary and tax liabilities by comparing to the December 20X5 payroll and cash book.

This article has attempted to introduce a general review of the audit acceptance and planning process. The reader should consult relevant texts and recommended readings for further details on the different aspects of the audit acceptance and planning process mentioned in this article.

Bibliography

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ISA 220 – Quality control for audits of financial statements.

ISA 300 – Planning an audit of financial statements.

ISA 315 - Identifying and assessing risks of material misstatement through understanding the entity and its environment.

ISA 320- Materiality in planning and performing an audit.