Introduction to Audit Planning

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INTRODUCTION

This article gives an introduction to audit planning, including:

- Purpose and methodology of audit planning
- Client acceptance and continuance
- Obtain knowledge of client's industry and business
- Assess client business risk
- Analytical procedures

PURPOSE AND METHODOLOGY OF AUDIT PLANNING

There are three main benefits from planning audits: it helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client.

ISA 300 Planning an Audit of Financial Statements requires that the planning stage of the audit should be used to establish an overall strategy for the audit, develop an audit plan, and reduce audit risk to an acceptably low level. The standard also requires that: 'Auditors should plan the audit work so that the engagement is performed in an effective manner.'

It is important to clarify what are meant by the terms "overall audit strategy" and "audit plan" as per ISA 300. The overall "audit strategy" describes in general terms how the audit is to be carried out and the "audit plan" details the specific procedures to be carried out to implement the strategy and complete the audit.

It is also important for students to understand the precise meaning of the risk terms: "audit risk" and "inherent risk" as both risks influence how the audit is carried out and the costs involved. The auditor will spend quite a bit of time at the early planning stages obtaining information to assess these risks so that "the engagement is performed in an effective manner".

"Audit risk" is the risk that an auditor may give an inappropriate audit opinion on financial statements that are materially misstated. To reduce the audit risk to an acceptably low level means the auditor needs to be more than certain that the financial statements are not materially misstated. This is reiterated by ISA 200, which states, "The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit."

"Inherent Risk" as per ISA 400 is "the susceptibility of an account balance or class of transactions to misstatements that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there are no related internal controls".

Assessing audit risk and inherent risk is an essential part of audit planning because it determines the quantity and quality of evidence that will need to be gathered and the staff that need to be assigned to the particular audit. If for example there were valuation issues with property inherent risk would then be assessed as high, therefore meaning more evidence would have to be gathered and staff that are more experienced assigned to perform testing on this account.

ACCEPT CLIENT AND PERFORM INITIAL AUDIT PLANNING

ISA 300 paragraph 6 states that the auditor should:

- Perform procedures regarding the continuance of the client relationship and the specific audit engagement
- Evaluate compliance with ethical requirements, including independence (also refer to ISA 220 Quality Control paragraphs 8 -12)
- Establish an understanding of the terms of the engagement (also refer to ISA 210 Terms of Audit Engagement).

CLIENT ACCEPTANCE AND CONTINUANCE

Client acceptance and continuance encompasses both deciding on acquiring a new client or continuation of relationship with an existing one and the type and amount of staff required. ISQC 1 states that audit firms should establish policies and procedures for the acceptance and continuance of client relationships. Typical policies and procedures involved in this process are:

1. Evaluate the client's background;
2. Determine whether the auditor is able to meet the ethical requirements regarding the client;
3. Communicate with the previous auditor;
4. Determine need for other experts;
5. Select staff to perform the audit and;
6. Obtain an engagement letter.

NEW CLIENT

Prior to accepting a new client, the auditor should investigate the client before accepting them. The auditor should evaluate the client's standing in the business community, financial stability, and relations with its previous auditor. The main purpose of investigating a new client is to ascertain the integrity of the client and the possibility of fraud. The auditor should be especially concerned with the possibility of fraudulent financial reporting since it is difficult to uncover. The auditor does not want to expose him or herself to the possibility of legal liability for failure to detect fraud. If the client has been audited previously, under ISA 300 the new auditor should contact the previous auditor, in compliance with relevant ethical requirements, in order to evaluate whether to accept the engagement. Both the new auditor and the previous auditor must obtain permission from the client before communication can be made because of the confidentiality requirement in the *Auditors Code*. The new auditor should be wary of accepting the client if the client does not give permission for this communication to the new auditor and/or the previous auditor. The previous auditor in compliance with relevant ethical requirements is required to respond to the new auditor's request for information if given permission by the client. Even when a potential client has been audited previously, the auditor may make other enquiries by collecting information from bankers, legal representatives, and background searches of relevant databases.

CONTINUING CLIENTS

Past arguments over the scope of the audit, the type of opinion issued, fees etc may give the auditor pause to reconsider the association with the particular client. The auditor may also decide to discontinue the relationship if the client is deemed to lack integrity. Under the Ethical Standards the auditor may have to discontinue association if there are ethical issues (if the client is involved in litigation against the auditor, there are unpaid fees, independence issues etc.). The auditor may also decide the particular engagement is too high risk.

Client acceptance and continuance is an important part of determining audit risk.

OBTAINING AN UNDERSTANDING WITH THE CLIENT

A clear understanding of the terms of the engagement should exist between the client and the auditor. ISA 210 describes the contents of an engagement letter. Although the standard does not require use of an engagement letter, the guidance is provided in a manner that presumes use of an engagement letter. According to ISA 210, 'the auditor and the client should agree on the terms of the engagement.' ISA 210 states that the auditor should ensure that the engagement letter or other form of suitable contract documents and confirms the auditors' acceptance of the appointment and includes a summary of the responsibilities of those charged with governance and of the auditor. The terms of the engagement include consideration of what is to be done (the objective, scope, and report of the audit) by who (the staff) and for how much (the fee). The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract. The engagement letter may also include an agreement to provide other services such as tax returns. It should also state any assistance to be provided by the client personnel in obtaining books and records, and schedules to be prepared for the auditor. It will outline the auditor's responsibilities in relation indictable offences and money laundering. It also serves the purpose of informing the client that the auditor cannot guarantee that all fraud will be detected.

DEVELOP OVERALL AUDIT STRATEGY

ISA 300 necessitates that the overall audit strategy should be established at the beginning, and updated and amended as required during the course of the audit. The auditor may need to revise his Overall Audit Strategy and Overall Audit Plan (and thereby the planned nature, extent and timing of further audit procedures) when unexpected events, changed conditions or the audit evidence achieved from audit procedures lead to information that is significantly different from information available to the auditor when he first planned his audit.

The purpose of the overall audit strategy is to develop an effective response to the risk of material misstatement. The auditor considers what they found in preliminary planning activities such as client acceptance, ethical position of the audit firm and their understanding of the entity and its environment, including its internal control, to develop an effective and efficient overall audit strategy that will appropriately respond to assessed risks.

The overall audit strategy includes consideration of planned audit responses to specific risks through the development of the audit plan. The overall audit strategy also helps the auditor determine the resources required for the engagement, including engagement staffing.

Therefore, at a minimum the following matters should be included in the overall audit strategy:

- Relevant characteristics of the audit engagement, such as the reporting framework used in order to set the scope of the engagement.
- Key dates for reporting and other communications
- Setting of materiality
- Preliminary risk assessment and whether internal controls are to be tested
- Consideration of resources available and how they are to be used

SELECT STAFF FOR ENGAGEMENT

Appropriate staff, knowledgeable about the client's industry, must be assigned to the engagement.

In order that they may effectively carry out their work, the assigned engagement staff should have the following capabilities and competencies:

1. An understanding of, and practical experience with, audit engagements of similar nature and complexity through appropriate training and participation.
2. Appropriate technical knowledge, including knowledge of relevant information technology.
3. Knowledge of relevant industry in which the client operates.
4. Ability to apply professional judgement.
5. An understanding of the firm's quality control policies and procedures
6. An understanding of professional standards and regulatory and legal requirements.

For existing clients there may also be a need for continuity from year to year. In addition, ISA 300 states that 'The auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and review of their work'.

In reviewing the work of engagement team members, it should be ensured that:

1. The work has been performed in accordance with professional standards and regulatory and legal requirements
2. The work performed supports the conclusions reached
3. The work performed is appropriately documented.
4. The evidence obtained is sufficient and appropriate to support the auditor's report.
5. The objectives of the engagement have achieved.

6. Any need to revise the nature, timing and extent of audit work performed has been identified
7. Significant matters have been raised for further consultation
8. Appropriate consultations have taken place and the resulting conclusion have been documented and implemented.

The engagement team will usually consist of a partner, manager, audit senior and junior.

EVALUATE NEED FOR OUTSIDE EXPERTS

ISA 620 defines an expert as a person or firm possessing special skill, knowledge, and experience in a particular field other than accounting and auditing. The auditor must have an understanding of the client's business sufficient to identify whether an expert is needed e.g. where inventory is highly specialised and is material to the financial statements independent valuation by an expert may be necessary. Where an expert's work is needed as audit evidence, the auditor should evaluate the expert's skills and competence by considering professional qualifications, experience, and reputation. The expert's objectivity should be considered.

UNDERSTAND THE CLIENT'S BUSINESS AND INDUSTRY

ISA 310 requires a reasonable understanding of the client's business and industry. The nature of the client's business and industry affects client business risk and the risk of material misstatement in the financial statements. Auditors use the knowledge of these risks to determine the appropriate amount of audit evidence to gather. Auditors have been exposed to problems resulting from the auditor's failure to understand comprehensively the nature of transactions in client's industry.

The auditor must also have an understanding of the client's external environment, including economic conditions, impact of competition, reporting obligations, legal and regulatory requirements. The auditor should source this information by reading industry trade publications, and regulatory requirements.

The auditor should identify factors such as major sources of income, key customers and suppliers, sources of finance, related parties and transactions with related parties requiring disclosure that may be high-risk areas within the client. The auditor should make inquiries of management and others within the entity in relation to the above. Visiting the client's premises is also useful in this regard because it gives an opportunity to observe operations firsthand and to meet key employees. Transactions with related parties are important to auditors because the International Accounting Standards require that such transactions be disclosed in the financial statements if they are material.

As management are pivotal in establishing an entity's strategies and business processes the auditor should consider management's philosophy and operating style and its ability to identify and respond to risks as this significantly affects the risk of material misstatement in the financial statements. In this regard, the auditor should read the memorandum and articles of association, read minutes of board of directors and shareholders, and inquire of management.

The auditor should understand the client's objectives related to reliability of financial reporting; effectiveness and efficiency of operations; and compliance with laws and regulations. Auditors need knowledge about operations to assess client business risk and inherent risk in the financial statements. The auditor should make inquiries of management; review prior year working papers; inspect legal documents (such as share options and pension plans), minutes of meetings and significant contracts.

The auditor needs also to consider to client's performance measurement system. Inherent risk may be increased if the client has set unreasonable objectives or if the performance measurement systems encourage manipulation of amounts in the financial statements. The auditor should read financial statements, perform ratio analysis, and inquire of management about key performance indicators that management uses to measure progress toward its objectives.

ASSESS CLIENT BUSINESS RISK

The auditor uses knowledge gained from the strategic understanding of the client business and industry to assess client business risk, the risk that client will fail to achieve its objectives. It is management's responsibility to identify the business risks facing the company and respond accordingly to those risks. The auditor's main concern is the risk of material misstatement in the financial statements due to client business risk. It is important to note that not all business risks will turn into risks leading to material misstatement in the financial statements.

ISA 315 stresses the importance of all members of the audit team understanding the potential risk of misstatements in each client's financial statements. In particular, the standard introduces the concept that the auditor is required to obtain an understanding of business risks and significant risks to the extent that they are relevant to the financial statements.

ISA 315 requires the audit team to discuss risk factors as part of the audit planning process.

PERFORM PRELIMINARY ANALYTICAL PROCEDURES

Analytical procedures applied at the planning stage can assist the auditor in gaining an understanding of the client's business and in assessing client business risk. ISA 520 states, "The auditor should apply analytical procedures at the planning and overall review stages of the audit."

ISA 520 Analytical Procedures states that analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimate for depreciation
- Similar industry information, such as comparison of the entity's ratio of sales to receivables with industry averages or with other entities of comparable size in the same industry.

Application of analytical procedures may indicate aspects of the business of which the auditor was unaware. In order to gain a better understanding of the client's business and industry, the auditor will calculate typical ratios and compare the company ratios to those of the industry. Analytical procedures identify significant deviation from predicted amounts, which show the auditor where to increase procedures to obtain corroborative evidence.

ISA 315 paragraph 10 contains additional guidance on applying analytical procedures as risk assessment procedures.

ADDITIONAL PARTS OF AUDIT PLANNING

This article has attempted to introduce the process of audit planning. However, other areas in relation to audit planning which have not been discussed in any depth in this article and where students should be able to answer examination questions on include:

- Setting materiality and assessing audit risk and inherent risk
- Understanding internal control and assessing control risk
- Gathering information to assess fraud risks
- Developing an audit plan.