**Chapter Three**

**PLANNING AND AUDITING PROCESS**

3.1 Audit Planning & Documentation

* 1. **PLANNING THE AUDIT**

The first generally accepted auditing standards of fieldwork requires adequate planning to be made before auditing is carried out.

**The wok is to be adequately planned, and assistants, if any, are to be properly supervised.**

***Reasons for proper Audit Plan***

bd14868_ To enable the auditor to obtain sufficient competent evidence

bd14868_ To help keep audit costs reasonable

bd14868_ To avoid misunderstanding with the client

**Obtaining sufficient competent evidence** is essential if the CPA firm is to minimize legal liability and maintain a good reputation in the business community. **Keeping costs reasonable** helps the firm remains competitive and thereby retains or expands its client base, assuming the firm has a reputation for doing high-quality work. **Avoiding misunderstanding with the client** is important for good client relations and for facilitating high-quality work at reasonable cost.

**Audit planning includes the following steps:**

Preplan

Obtain background

Information

Obtain information about client’s legal obligations

Perform preliminary

Analytical procedures

Set materiality, and assess acceptable audit risk and inherent risk

Understand internal control and assess control risk

Develop overall audit plan and audit program

**3.1.1.** Preplan the audit-It involves three things, all of which should be done early in audit. First, the auditor decides whether to accept a new client or continue serving an existing one. This is typically done by an experienced auditor who is in a position to make important decisions. The auditor wants to make that decision early, before incurring any significant costs that can not be recovered. Second, the auditor identifies why the client wants or need an audit. This information is likely to affect the remaining part of the planning process. Thirdly, the auditor obtains an understanding with the client about the terms of the engagements to avoid misunderstandings and staff the engagements.

**Client acceptance procedure**

**i) Obtaining clients**-As a starting point, it is essential for an auditor or auditors/audit firms/ to maintain its integrity, objectivity, and reputation for providing high-quality services. No auditor can afford to be regularly associated with clients who are engaging in management fraud or other misleading practices. The continuing wave of litigation involving auditor underscores the need for audit firms to develop quality control policies for thoroughly investigating prospective clients before accepting an engagement. The auditor should investigate the history of prospective client, including such matters as the identities and reputations of the directors, officers and major stockholders, financial strength and credit rating of a prospective client to help assess the overall risk associated with particular business (business risk).

In addition to considering business risk the auditors should consider:

* Whether they can complete the audit in accordance with generally accepted auditing standards
* Whether there are any conditions that would prevent them from performing an independent audit of the client.
* Whether the partners and staff have appropriate training and experience to competently complete the engagement.

1. Submitting a proposal- To obtain the audit, the auditors may be asked to submit a competitive proposal that will include information on the nature of services that the firm offers, the qualifications of the firm’s personnel, anticipated fees, and other information to convince the prospective client to select the firm.
2. Communication with audit committees- Arrangements for the audit may be made through contact with the company’s audit committee (if any). An audit committee must be composed of at least three independent directors. During the course of the audit the discussions with the audit committee members will focus on:

* Weakness in internal control
* Proposed audit adjustments
* Disagreement with management as to accounting principles
* The quality of accounting principles used by the company
* Indications of management fraud other illegal acts by corporate officer.

iv). Fee Arrangements-when the business engages in the services of independent public accountants, it will usually ask for an estimate of the cost of the audit. Staff time is the basic unit of measurements for audit fees. It involves the application of the audit firm’s daily or hourly rates to the estimated time required. Other direct costs such as staff travel costs, report processing costs and other out-of-pocket expenditures are also included in the cost of audit.

V) Communication with predecessor auditors – According to Statement of Auditing Standards (SAS-84) “Communication between predecessor and successor Auditors” requires the successor auditors to communicate with the predecessor before accepting an engagement. When predecessor auditor is permitted by the client company to communicate (When there is the consent of client’s to give confidential information), the successor auditors’ inquiries may include questions about:

* Disagreement with management over accounting principles
* The predecessor’s understanding of the reasons for the change in auditors
* On the nature of client’s internal control structure
* Other matters that will assist the successor auditors in deciding whether to accept the engagement

VI) Engagement Letters- The auditors should establish an understanding with the client regarding the services to be performed, the objectives of the engagement, management’s responsibilities, auditor’s responsibilities, scope and/or limitations of the engagements and other related issues.

**3.1.2. Obtain background information-** An extensive understanding of the client’s business and industry and knowledge about the company’s operations are essential for doing an adequate audit. Most of this information is obtained at the client’s premises, especially for a new client.

a) Obtain knowledge about the client’s industry and business-There are three primary reasons for obtaining a good understanding of the client’s industry. First, many industries have unique accounting requirements that he auditor must understand to evaluate whether the client’s financial statements are in accordance with generally accepted accounting principles. For example, if an auditor is doing an audit of a city, the auditor must understand governmental accounting and auditing requirements. There are also unique accounting requirements for construction companies, rail roads, non for profit organizations, financial institutions, and many other organizations.

Second, the auditor can often identify risks in the industry that may affect the auditor’s assessments of accepting audit risk, or even whether auditing companies in the industry is advisable. As stated earlier, certain industries are more risky than others, such as the savings and loan and health insurance industries.

Thirdly, there are inherent risks that are typically common to all clients in certain industries. Understanding those risk aids the auditor in identifying the client’s inherent risks. Examples, include potential inventory obsolescence inherent risk in the fashion clothes industry, accounts receivable inherent risk in the consumer loan industry, and reserve for loss inherent risk and causality insurance industry

Knowledge of the client’s industry can be obtained in different ways. These include discussions with the auditor who was responsible for the engagement in previous years and auditors currently on similar engagements, as well as conferences with the client’s personnel. Knowledge about the client’s business that differentiates it from other companies in its industry is also needed. That knowledge will help the auditors more effectively assess acceptable audit risk and inherent risk and will be useful in designing analytical programs.

b) Tour the client plant and offices-A tour of the client’s facilities is helpful in obtaining understanding of the client’s business and operations because it provides opportunity to observe operations firsthand and to meet key personnel. The actual viewing of the physical facilities aids in understanding physical safeguards over assets and in interpreting accounting data by providing a frame of reference in which to visualize such assets as inventory in process and factory equipment. Knowledge of the physical layout also facilities getting answers to questions later in the audit. The tour may also help the auditors identify inherent risks. For example, if the auditor observe unusual inventory, it will affect the assessment of inherent risks for equipment and inventory. Discussion with non accounting employees during the tour and throughout he audit are useful in maintaining a board perspective.

c) Identify related parties-Transactions with related parties are important to auditors because generally accepted accounting principles require that they be disclosed in the financial statements if they are material. Transactions with a related party are not arm’s length transactions. Therefore, there is a risk that they were not valued at the same amount as they would have been if the transactions had been with an independent third party. The disclosure requirements include the nature of the related party relationships; a description of transactions, including dollar amounts; and amounts due from and to related parties. Most auditor assess inherent risk as high for related parties and related party transactions, both because of the accounting disclosure requirements and the lack of independent between the parties involved in the transactions.

A related party is defined in SAS-45 as an affiliated company, a principal owner of the client company, or any other party with which the client deals where one of the parties can influence the management or operating policies of the other. A related party transaction is any transaction between the client and a related party. Common examples include sales or purchase transactions between a parent company and subsidiary, exchange of equipment between two companies owned by the same person, and loans to officers. A less common example is the exercise of significant management influence on an audit client by its most important customers.

Because material related party transactions must be disclosed, it is important that all related parties be identified and included in the permanent files early in the engagement. Finding undisclosed related party transactions is thereby enhanced. Common way of identifying related parties include inquiry of management, review of SEC filings, and examinations of stockholder’s listings to identify principal stockholders.

d) Evaluate need for outside specialists-when the auditor encounters situations requiring specialized knowledge, it may be necessary to consult a specialist. SAS-73 establishes the requirement for selecting specialists and reviewing their work. Examples include using a diamond expert in evaluating the replacement cost of diamonds and an actuary for determining the appropriateness of the recorded value of insurance loss reserves. Another common use of specialist is consulting with attorneys on the legal interpretations of contracts and titles. In the case of a large inventory of computer and computer parts, the audit firm may deicide to engage a specialist if no one within the firm is qualified to evaluate whether the inventor is obsolete or not.

The auditor should have a sufficient understanding of the client’s business to recognize the need for a specialist. The auditor should also evaluate the specialist’s professional qualifications and understand the objectives and scope of the specialist’s work. The auditor should also consider the specialists relationship with the client, including circumstances that might impair the specialist’s objectivity.

**3.1.3. Obtain information about client’s obligations-**three closely related types of documents and records should be examined early in the engagement: corporate charter and bylaws, minutes of board of directors’ and stockholders’ meetings, and contracts. Some information, such as contacts, must be disclosed in the minutes is useful in other parts of the audit. Early knowledge of these legal documents and to records enables auditors to interpret related evidences throughout the engagement and to make sure there is proper disclosure in the financial statements.

a) Corporate charters and Bylaws- The corporate charter is granted by the state in which the company is incorporated and is the legal document necessary for recognizing a corporations as a separate entity. It includes the exact name of the corporations, the date of incorporations, the kinds and amounts of capital stock the corporation is authorized to issue, and the type of business activities the corporation is authorized to conduct. In specifying the kinds of capital stock, there is also included such information as the voting rights of each class of stock, par or stated value of the stock, preferences and conditions necessary for dividends, and prior rights in liquidations.

The bylaws include the rules and procedures adopted by the stockholder of the corporation. They specify such things as the fiscal year of the corporation, the frequency of stockholder meetings, the methods of voting for directors, and the duties and powers of the corporate officers.

The auditors must understand the requirements of the corporate charter and the bylaws to determine whether the financial statements are properly presented. The correct disclosure of the stockholder’s equity, including the proper payments of dividends, depends heavily on these requirements.

b) The corporate minutes of meetings- are the official record f the meetings of the board of directors and stockholders. They include summaries of the most important topics discussed at these meetings and the decisions made by the directors and stockholders. The auditor should read the minutes to obtain information that is relevant to performing the audit. There are two categories of relevant information in minutes: Authorizations and discussions by the board of directors affecting inherent risk.

Common authorizations in the minutes include compensation of officers, new contracts and agreements, acquisitions of property, loans, and dividend payments. While reading the minutes, the auditor should identify relevant authorizations and include the information in the working papers by making an abstract of the minutes or by obtaining a copy and underling significant portions. Some time before the audit is completed, there must be a follow-up of this information to be sure that management has complied with actions taken by the stockholder and the board of directors. As an illustration, the authorized compensation of officers should be traced to each individual officer’s payroll records as a test of whether the correct total compensation was paid.

Similarly, the auditor should compare the authorizations of loans with notes payable to make certain that these liabilities are recorded. Information included in the minutes affecting the auditor’s assessment of inherent risk is likely to involve more general discussions.

* + - 1. Contracts- Clients become involved in different types of contracts that are of interest to the auditors. These can include such diverse items as long-term notes and bond payable, stock options, pension plans, contracts with vendors for future delivery of supplies, government contracts for completion and delivery of manufactured products, royalty agreements, union contracts and leases and others.

Most contracts are of primary interest in individual parts of the audit and, in practice, receive special attention during the different phases of the detailed tests. For example, the provisions of a pension plan would receive substantial emphasis as a part of the audit of the unfunded liability for pensions. The auditor should review and abstract the documents early in the engagement to gain a better perspective of the organization and to become familiar with potential problem areas. Later these documents can be examined more carefully as a part of the tests of individual audit areas.

The existence of contracts often affects the auditor’s assessed inherent risks. To illustrate assume that the auditor determines early in the audit that the client has signed several sales contract with severe nonperformance clauses committing the company to deliver specified quantities of its product at agreed-upon prices during the current and next 5-years. The inherent risks for total sales, liabilities for penalties, and sales commitment disclosures are likely to be assessed as high in this situation.

**3.1.4 Perform preliminary analytical procedures**

Auditors are required to perform analytical procedures while planning the audit to assist in determining the nature, timing, and extent of auditing procedures. Analytical procedures performed during the planning phases enhance the auditor’s understanding of the client’s business and events occurring since the prior year’s audit. Planning analytical procedures also help the auditors identify areas that may represent specific risks of material misstatements warranting further attention.

Analytical procedures used in planning are often based on aggregate, companywide data. For some clients, reviewing changes in account balances on the trial balance may be sufficient for planning purposes. Along with comparative industry information, auditors might consider key financial ratios such as efficiency ratio, return on assets, liquidity ratio, inventory and accounts receivable turn over ratios and other similar rations. The collectability of accounts receivable and inventory obsolescence may also receive additional attention of the auditor.

**3.1.5. Set materiality and assess acceptable audit risk and inherent risk**

The scope paragraph in auditors’ reports includes two important phrases that are directly related to materiality and risk. These phrases are emphasized in bold italic print in the following two sentences of a standard scope paragraph.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material statements.

The phrase *obtained reasonable assurance* is intended to inform users that auditors do not guarantee or ensure the fair presentation of the financial statements. The phrase communicate that there is some risk that the financial statements are not fairly stated even when the opinion is unqualified.

The phrase *free of material misstatement* is intended to inform users that the auditor’s responsibility is limited to material financial information. Materiality is important because it is impractical for auditors to provide assurance on immaterial amounts.

Thus, materiality and risk are fundamental concepts that are important to planning the audit and designing the audit approach. Materiality is a major consideration in determining the appropriate audit report to issue.

FASB has defined materiality as

The magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it *probable* that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

The auditor’s responsibility is to determine whether financial statements are materially misstated. If the auditor determines that there is a material misstatement, he or she will bring it to the client’s attention so that there is a material misstatement, he or she will bring it to the client’s attention so that a correction can be made. If the client refuses to correct the statements, a qualified or an adverse opinion must be issued, depending on how material the misstatement is. Therefore, auditors must have a thorough knowledge of the application of materiality.

A careful reading of the FASB definition reveals the difficulty that auditors have in applying materiality in practice. The definition emphasizes reasonable users who rely on the statements to make decisions. Therefore, auditors must have knowledge of the likely users of their client’s statements and the decisions that are being made. For example, if an auditor knows that financial statements will be relied on in a buy- sell agreement for the entire business, the amount that the auditors material may be smaller than for an otherwise similar audit. In practice, the auditors may not know who all users are or what decisions will be made.

There are five closely related steps in setting materiality. These are:

Step-1: Set preliminary judgment about materiality Planning extent

Step-2: Allocate preliminary judgment about materiality to segments of test

Step-3: Estimate total misstatement in segments

Step-4: Estimate the combined misstatements evaluating results

Step-5: Compare combined estimate with preliminary

or revised judgment about materiality

Step-1: Setting a preliminary judgment about materiality- Ideally, an auditor decides early in the audit the combined amount of misstatement in the financial statements that would be considered material. SAS-47 defines the amount as the preliminary judgment about materiality. This judgment need not be quantified but often is. It is called a preliminary judgment about materiality because it is a professional judgment and may change during the engagement if circumstances change. The preliminary judgment about materiality is thus, the maximum amount by which the auditors believes the statements could be misstated and still not affect the decisions of reasonable users

The reason for setting a preliminary judgment about materiality is to help the auditors plan the appropriate evidence to accumulate. If the auditor sets a low dollar amount, more evidence is required than for a high amount.

Factors affecting materiality judgment- Several factors affects a preliminary judgment about materiality for a given set of financial statements. The most important of these are discussed below.

* + 1. Materiality is a relative term- a misstatements of a given magnitude might be material for a small company, whereas the same dollar misstatement could be immaterial for a large one.
    2. Bases are needed for evaluating materiality-Because materiality is relative, it is necessary to have bases for establishing whether misstatements are material. Net income before taxes is normally the primary base for deciding what is material because it is regarded as a critical item of information for users
    3. A qualitative factor also affects materiality- certain types of misstatements are likely to be more important to users than others, even if the dollar amounts are the same. For example,
* Amounts involving fraud are usually considered more important that unintentional errors of equal dollar amounts because fraud reflects on the honesty and reliability of the managements or other personnel involved. For example total of $100,000 may extremely material for small company while it could be immaterial for large company case.
* Misstatements that are otherwise minor may be material if there are possible consequences arising from contractual obligations. An example is when net working capital included in the financial statements is only a few hundred dollars more than the required minimum in a loan agreement.
* Misstatements that are otherwise immaterial may be material if they affect a trend in earnings. For example, if reported income has increased by 3-percent annually for the past 5-years but income for the current year has declined by 1-percent, that change of trend may be material.

Step-2: Allocate preliminary judgment about materiality to segments (tolerable misstatements)

The allocation of the preliminary judgment about materiality to segments is necessary because, evidences are accumulated by segments rather than for the financial statements as a whole. If auditors have preliminary judgments about materiality for each segment, it helps them decide the appropriate audit evidence to accumulate. For example, an auditors is likely to accumulate more evidences for an accounts receivable balance of $1,000,000 when a misstatement of $50,000 in accounts receivable is considered material than if $300,000 were material. When auditors allocate the preliminary judgment about materiality to accounts balance, the materiality allocated to any given accounts balance is referred to in SAS-39 as tolerable misstatements

Step-3: Estimate total misstatement in segments- When auditors perform audit procedures for each segment of the audit, a worksheet is kept of all misstatements found. For example, assume that the auditor finds six client misstatements in a sample of 200 in testing inventory costs. These misstatements are used to estimate the total misstatements in inventory. The total is called an estimate or often called a “projection” because only a sample, rather than the entire population, was audited.

Step-4: Estimate the combined misstatements-Estimation of projected misstatements is required by SAS-39. The projected misstatements amounts for each account are combined on the worksheet.

Step-5: Compare combined estimate with preliminary or revised judgments about materiality- The combined misstatements of certain amount may exceeds the preliminary judgment about materiality of a given amount. In such cases, since the estimated combined misstatements exceed the preliminary judgment, the financial statements are not acceptable. The auditor can either determine whether the estimated misstatements actually exceed

a given amount of preliminary judgment by performing additional audit procedures or require the client to make an adjustment for estimated misstatements

**3.1.6 Understand internal control and assess control risk-**To effectively assess internal control for the purpose of reducing planned audit evidence, auditors need to understand key internal control and control risk concepts. As discussed in previous chapter, a system of internal control consists of policies and procedures designed to provide managements with reasonable assurance that the company achieves its objective and goals. These policies and procedures are often called control especially those controls related to the reliability of financial reporting , are important to the auditors purpose.

**3.1.7: Develop over all audit plan and audit program-I**t deals the last step in the planning phase of audit. It is critical step because it results in the entire audit program the auditors plans to follow in the audit, including all audit procedures, sample size, items to select, and timing. It is the process of making correct decisions in both the effectiveness of evidences and the efficiency of the audit process.

***3.2 Overview of the Audit Process***

The phases of the audit include…client acceptance and retention, Establish the terms of the engagement, Plan the audit, Consider internal control, Conduct substantive tests, Feedback on the results of the audit work in these phases, Complete the audit and Issue audit report

**Client Acceptance and Retention**

The Statements on Quality Control Standards require that public accounting firms establish policies and procedures for deciding whether to accept new clients or retain current clients. The purpose of such policies is to minimize the likelihood that an auditor will be associated with clients who lack integrity. If an auditor is associated with a client who lacks integrity, material misstatements may exist and not be detected by the auditor. This can lead to lawsuits brought by users of the financial statements.

In discussing this issue, a distinction is made between evaluating a prospective client and continuing a current client. In the case of a continuing client, the auditor has more first hand knowledge about the entity’s operations and management’s integrity.

**Prospective Client Acceptance**

Public accounting firms should investigate a prospective client prior to accepting an engagement. Performance of such procedures would normally be documented in a memo or by completion of a client acceptance questionnaire or checklist. The successor auditor’s communications with the predecessor auditor should include questions related to the integrity of management; disagreements with management over accounting and **auditing** issues; communications with audit committees or an equivalent group regarding fraud, illegal acts, and internal-control-related matters; and the predecessor’s understanding of the reason for the change in auditors.

If the client has not previously been audited, the public accounting firm should complete all the procedures listed below, except for the communication with the predecessor auditor.

**Procedures for evaluating a prospective client:**

1. Obtain and review available financial information (annual reports, interim financial statements, income tax returns, etc.).

2. Inquire of third parties about any information concerning the integrity of the prospective client and its management. (Such inquiries should be directed to the prospective client’s bankers and attorneys, credit agencies, and other members of the business community who may have such knowledge.)

3. Communicate with the predecessor auditor about whether there were any disagreements about accounting principles, audit procedures, or similar significant matters.

4. Consider whether the prospective client has any circumstances that will require special attention or that may represent unusual business or audit risks, such as litigation or going-concern problems.

5. Determine if the firm is independent of the client and able to provide the desired service.

6. Determine if the firm has the necessary technical skills and knowledge of the industry to complete the engagement.

7. Determine if acceptance of the client would violate any applicable regulatory agency requirements or the Code of Professional Conduct.

**Continuing Client Retention**

Public accounting firms need to evaluate periodically whether to retain their current clients. This evaluation may take place at or near the completion of an audit or when some significant event occurs. Conflicts over accounting and **auditing** issues or disputes over fees may lead a public accounting firm to disassociate itself from a client.

The auditor should establish an understanding with the client regarding the services to be performed. For small, privately held entities, the auditor normally negotiates directly with the owner-manager. For larger private or public entities, the auditor will normally be appointed by a vote of the stockholders after recommendation by the audit committee of the board of directors. In all cases, an engagement letter should document the terms agreed to by the auditor and client. Such terms would include, for example, the responsibilities of each party, the assistance to be provided by client personnel and internal auditors, and the expected audit fees.

**Audit Planning**

Proper planning of an audit is important to ensure that the audit is conducted in an effective and efficient manner. The steps taken during this phase include (1) gaining knowledge of the client’s business and industry so that the auditor understands events, transactions, and practices that may affect the financial statements and (2) conducting preliminary analytical procedures (such as ratio analysis) to identify specific transactions or account balances that should receive special attention because they may contain material misstatements. In many instances, audit planning will include a preliminary consideration of the client’s internal control system.

Based on this initial work, an overall audit strategy is developed. This includes the preliminary assessment of materiality and audit risk, as well as an audit plan involving the types of audit procedures to be performed and the amount of evidence to be gathered. The audit plan serves as a starting point for the engagement, but adjustments may be required as the audit progresses.

**Assessment of Internal Control**

Internal control is a process affected by an entity’s board of directors, management, and other personnel that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

(1) Effectiveness and efficiency of operations,

(2**2**) Reliability of financial reporting, and

(3) Compliance with applicable laws and regulations.

The auditor must sufficiently understand the client’s internal controls in order to determine which controls exist within the entity. The auditor then evaluates the internal controls in order to assess the risk that they will not prevent or detect a material misstatement in the financial statements. This risk (referred to as *control risk*) directly impacts the scope of the auditor’s work. When the auditor assesses control risk at less than the maximum, the internal controls should be tested. The auditor’s tests are intended to ensure that the internal controls are operating in the manner intended and therefore are effective in preventing or detecting misstatements. The evidence gathered from testing the internal controls is used to arrive at a final assessment on the level of control risk. When control risk is assessed low, based on tests of the internal controls (referred to as *tests of controls*), less audit work is required to audit the account balances (referred to as *substantive tests*) because the auditor has evidence that the accounting systems are generating materially accurate financial information. Conversely, if control risk is high, the auditor has to conduct more extensive audit work in the account balances because the evidence about internal controls suggests that material misstatements could occur because controls do not exist or are not operating effectively.

**Conduct Substantive Tests**

In this phase, the auditor conducts more analytical procedures and examines the details of the account balances. For example, the auditor may calculate an estimate of interest expense by multiplying total debt by the average interest rate on the entity’s debt. This estimate of interest expense can be compared to interest expense reported in the general ledger for reasonableness. The purpose of such analytical procedures is to determine whether the accounts contain a material misstatement. On most engagements, this phase comprises most of the time spent on the audit.

**Complete the Audit**

After the auditor has completed testing the account balances, the sufficiency of the evidence gathered needs to be evaluated. The auditor must have sufficient competent evidence in order to reach a conclusion on the fairness of the financial statements. In this phase, the auditor also assesses the possibility of contingent liabilities, such as lawsuits, and searches for any events subsequent to the balance sheet date that may impact the financial statements.

**Issue the Audit Report**

The final phase in the audit process is choosing the appropriate audit report to issue. When the auditor has gathered sufficient competent evidence and complied with GAAS, and the financial statements conform to GAAP, the auditor can issue a standard unqualified audit report. When sufficient evidence is not gathered or the financial statements are not in accordance with GAAP, the auditor will issue a different type of report.

PLANNING THE AUDIT

Audit planning involves the development of an overall strategy based on the understanding of the organization being audited, the environment in which it operates; the possible lines of enquiry and the kinds of information that should be gathered for the identified areas of audit. It integrates the various aspects of auditing task, which is aimed at achieving the primary objective of the audit, for example, enhancing the government accountability. The Planning also optimises the transfer of knowledge from one audit to another, with minimal cost and disruption to the audit entity.

Audit planning is a vital area of the audit which is primarily conducted at the beginning of the audit process. The plan developed will be revised as necessary during the course of the audit.

**Adequate planning includes:**

* Investigating a prospective client before deciding whether to accept the engagement
* Obtaining in understanding of the client business operations
* Developing an overall strategy to organize, coordinate, and schedule the activities of the audit staff ( develop overall audit strategy)
* Design a detail list of the audit procedures to be performed in the course of the examination(develop appropriate audit programs)

**Audit planning is a vital area of the audit process to help to:**

* + Determine the audit requirements
  + Determine the time budget
  + Assess the level of risk and materiality
  + Perform the audit work at effective manner
  + Acquire knowledge of the client's accounting systems, policies and internal control procedures
  + Establish the expected degree of reliance to be placed on internal control
  + Determine and program the nature, timing, and extent of the audit procedures to be performed
  + Ensure that appropriate attention is devoted to important areas of the audit
  + Ensure that potential problems are promptly identified
  + Ensure that the work is completed expeditiously
  + Utilize the assistants properly
  + Co-ordinate the work done by other auditors and experts

**Advantages of Audit Planning**

Audit planning is a continuous process and must continue throughout the audit. A properly drawn-up audit plan helps in the efficient and effective conduct of audit. Some of the main advantages of audit planning are: Audit planning helps in ensuring that adequate attention is devoted to important areas of the audit. Audit planning helps in identifying potential problems. Audit planning helps in ensuring that the audit work is completed expeditiously. Planning helps in utilising the staff properly. Audit planning acts as a direction. Audit planning acts as a direction for auditors in the planning, conducting and reporting of an audit assignment.

**The major steps in planning audit are:**

* Pre-plan the audit
* Obtain background information
* Obtain information about client’s legal obligations
* Set materiality and assess acceptable audit risk
* Understand internal control structure and assess control risk
* Develop the audit plan and audit program

The extent of planning will vary according to :-

* + The size of the entity
  + The complexity of the audit and the specific methodology of technology used by the auditor
  + The auditors experience with the entity and knowledge of the business

**Engagement Letter**

Having decided to accept a client, the first step the auditor should take is to send the client an engagement letter to set forth the terms of the type of engagement to be performed and to identify any understandings between the auditor and client. By returning a signed copy of the letter, the client agrees to cooperate, render assistance, and compensate the auditor. Many audit firms send engagement letters not only to new clients but also to continuing clients for each engagement, whether the services performed are for audit, tax, compilation, review, or some other special engagement. An engagement letter is a written contract between an auditor and client and generally serves as to:

* Minimize misunderstandings between the client and auditor
* Alert the client to the purpose of the engagement and the role of the external auditor
* Help to minimize legal liability for services neither contracted for nor performed
* Indicate the work to be performed by the client’s staff and client’s responsibilities. An engagement letter should explain in nontechnical language the nature of the services to be rendered and establish that the financial statements are the responsibility of the client.
* Indicate the scheduled dates for performance and completion of the examination, and the basis for computing the auditor’s fee
* Provide audit staff with an understanding of the nature of the engagement.

**Audit Risk**

In planning the audit, the auditor should make a preliminary judgment about whether or not the financial statements are materially misstated. Audit risk and materiality must be considered in the planning stages of the audit so that the auditor can determine the nature, timing, and extent of audit tests.

Audit risk *is* the risk of giving an inappropriate opinion when financial statements are materially misstated. Audit risk is the chance that a material misstatement exists in the financial statements and the auditors do not detect the misstatement with their audit procedures. The auditor should use professional judgment to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

In theory, audit risk ranges anywhere from zero, here there is complete certainty of no material misstatement, to one where there is complete certainty of a material misstatement. In practice, however, audit risk is always greater than zero. There is always some risk of material misstatement as it is not possible, (except for the audit of the simplest of financial statements), due to the limitations inherent in both accounting and auditing, to be absolutely certain a material misstatement will not exist.

The auditor must plan and perform the audit to obtain reasonable assurance those material misstatements, whether caused by errors, irregularities, or illegal acts are detected. The auditors’ concern about fraud does not stop at the planning phase of the audit. Throughout the engagement, they should be alert for conditions that may indicate that a fraud was committed.

***When Audit Risk increase:***

* Perform additional audit tests
* Modify the nature, extent and timing of the audit procedures to obtain evidence that is more reliable.
* Apply increased professional skepticism about material transactions; increase the nature and extent of the documentation examination.
* Assign personnel with particular skill in audit areas with high risk
* Obtain additional evidence about the appropriateness of management selection and application of significant accounting principles.
* Document the assessment of risk in working papers.
* Risk factors
* Responses
* Management representation

# Components of Audit risk

# Inherent risk**: the susceptibility of an account balance or class of transactions to material misstatement, irrespective of related internal controls. Inherent risk is greater for some financial statement assertions and related balances or classes of transactions than for others. For example, there is a greater risk of misstatement of the financial presentation and disclosure assertion for complex transactions than for simple ones. Likewise, the risk of a material misstatement of the existence assertion for cash is more likely than for an inventory of coal. Inherent risk factors include:**

**Control risk:** the risk that material misstatement could occur in an account balance or class of transactions with could not be prevented or detected by the accounting or internal control systems. The auditor’s understanding of the internal control system will allow the auditor to assess control risk and thus affect the auditor’s assessment of the risk of material misstatements. In reviewing risk factors and the internal control systems, the auditor should assess the risk of management misrepresentation.

**Detection risk:** the risk that auditor's substantive procedures do not detect a material misstatement in an account balance or class of transactions. This risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from the uncertainties that exist when the auditor does not examine all of an account balance or class of transactions to gather evidence on a particular assertion. Other uncertainties might arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning, supervision, and conduct of a firm’s audit practices in accordance with appropriate quality standards.

- More substantive procedures >↓ detection risk > sample size

- Detection risk > acceptance low level > qualified audit opinion

**The time budget is used as:**

* Basis of estimating fees
* As means of communication of the audit staff to indicate critical and time – consuming areas
* To measure efficiency of the audit work (review procedure)

**Audit Staffing**

Once having obtained an understanding of the client and its business and having designed the audit program, the auditor is in a position to determine how the engagement should be staffed. At this point, the auditor selects the audit team. The audit team should be selected based on the number of people needed, the experience levels desired, and the technical expertise required. Usually the audit team consists of one or more staff accountants, a senior, a manager, and a partner.

One important element of planning is to make sure that the audit team includes personnel who can adequately supervise inexperienced members on the audit, as required by the first standard of fieldwork. Sometimes, staff accountants may mechanically perform audit procedures based on the audit program and the prior-year working papers. Although the audit program and prior-year working papers are certainly good guides, they should not be mechanically followed. The important point is that that the senior or in-charge auditor should properly communicate and supervise the inexperienced auditor.

Often, the in-charge auditor will schedule a pre-audit conference with the audit team. A pre-audit conference allows the in-charge auditor to give guidance to the staff regarding both the technical and human-relations aspects of the audit, to establish good communications among the audit team, and to answer the staff’s questions.

**Planning a recurring engagement**:

The precious year audit is a good working knowledge of the clients business. Use Information from previous audit working papers.

**Use of the client’s staf**f:

* The auditors should obtain an understanding with the client on to the extent to which the client’s staff, including the internal auditors, can help prepare for the audit. The client’s staff should have the accounting records up – to-date when the auditors arrive. Among the tasks that may be assigned to the client’s employers are:
* the preparation of - trial balance of the general ledger
* Aging analysis of accounts receivables
* Analyses of account receivables written off
* List of property additions and retirements during the year
* Analyses of various revenue and expense accounts

#### The audit trail – a continuous trail of evidence that links the business transactions with the summary figures in the financial statements. The audit trail is a record left by the accounting information system of movements in individual transaction data. This record, in the form of references to the processing of the data, provides a trail of the processing of transactions and other events entered into by the entity. Note that while some accounting information systems provide a visible and complete audit trail, others may provide an invisible and/or incomplete trail.

* Depending on the accounting information system, the trail may start from the moment data about the event is first captured within the system to the time of its ultimate disposition in the financial statements. For example, the audit trail of a sales transaction may enable the tracing of the movement in data concerning the transaction from the time the order is placed by the customer until the time the transaction data is included in the appropriate general ledger accounts. The system records may also provide a link to other related transaction cycles. Continuing the example, the system may enable the linking of a particular sales transaction to the related cash receipt transactions and inventory transactions. These related transaction cycles may have their own audit trail. An auditor may follow the audit trail of a transaction as part of a systems walk-through.

**Direction of testing**: source document → financial statements

Source document ← financial statements