

Planning the Audit; Linking Audit Procedures to Risk



CHAPTER 6



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CHAPTER 6-1

REQUIREMENT

FIRST STANDARD OF FIELDWORK:

AN AUDIT IS TO BE ADEQUATELY PLANNED AND SUPERVISED.

RECALL THAT ANALYTICS ARE REQUIRED DURING PLANNING

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Items Included in Engagement Letters

- Name of the entity
- Management responsibilities
 - Financial statements
 - Establishing effective internal control over financial reporting
 - Compliance with laws and regulations
 - Making records available to the auditors
 - Providing written representations at end of the audit, including that adjustments discovered by the auditors and not recorded to the financials are not material
- Auditor responsibilities
 - Conducting an audit in accordance with GAAS/ PCAOB (if public)
 - Obtaining an understanding of internal control to plan audit and to determine the nature, timing and extent of procedures
 - Making communications required by GAAS
- FEES! Payment terms & anything else the parties negotiate

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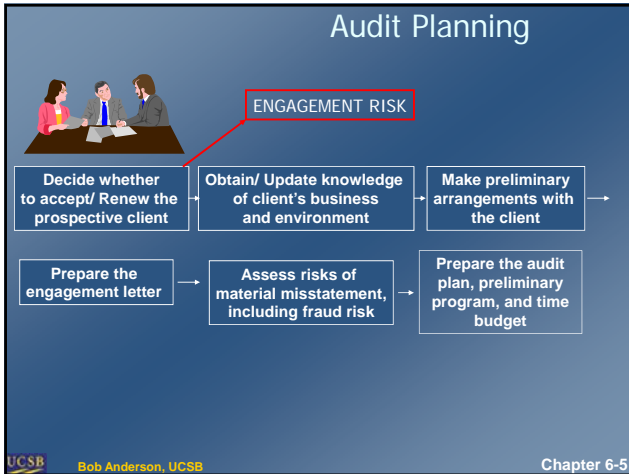
Engagement Letters--Optional Items

- Arrangements regarding
 - Conduct of the audit (e.g., timing, client assistance)
 - Use of specialists or internal auditors
 - Obtaining information from predecessor auditors
 - Fees and billing
- Other services to be provided, such as examination of internal control over financial reporting
- Limitation of or other arrangements regarding liability of auditors or client
- Conditions under which access to the auditors' working papers may be granted to others

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- ### Understanding the Client's Business—Nature of the Client
- Competitive position
 - Organizational structure
 - Accounting policies and procedures
 - Ownership
 - Capital structure
 - Product and service lines
 - Critical business processes
 - Internal control
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- ### Understanding the Client's Business—Industry, Regulatory, and Other Factors
- Competitive environment
 - Supplier and customer relationships
 - Technology developments
 - Major laws and regulations
 - Economic conditions
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- ### Understanding the Client's Business—Attractiveness of the Industry
- Barriers to entry
 - Strength of competitors
 - Bargaining power of suppliers of raw materials and labor
 - Bargaining power of customers
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Understanding the Client's Business—Objectives, Strategies & Business Risks

- Objectives—Overall plans
- Operating and financial strategies—Operational actions to achieve objectives
- Business risks—Threats to achieving objectives

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Understanding the Client's Business-- Basic Strategy

- Product differentiation
- Cost leadership

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Understanding the Client's Business—Measuring and Reviewing Performance

- Budgets
- Key performance indicators
- Segment performance reports
- Balanced scorecard
- External parties

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Sources of Information

- Inquiries of management
- Industry Accounting and Auditing Guides
- Industry Risk Alerts
- Government publications
- Prior company annual reports and SEC filings
- Prior tax returns
- Electronic sources
- Tour of plant and offices
- Analytical procedures

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A Note From the Instructor

I have polled every partner I know at every public accounting firm I know. The population is estimated to exceed 25 partners and 375 years of public accounting experience.

The chief goal of the audit boils down to identifying audit differences. Not one surveyed ever found an audit difference by studying internal controls.



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ANOTHER IMPORTANT NOTE

Risks- why do we care?

Ultimately we care if an identified risk would translate into a possible financial statement misstatement. We then want to understand and test the controls which we will rely upon to mitigate those risks. Finally we perform substantive audit procedures to mitigate any remaining risk.

Do you think the exercise to understand the client business may identify risks which do not have a possible impact to the financial statements?

YES

Should we investigate those risks further?

PROBABLY NOT



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Developing an Overall Audit Strategy

- Planning materiality
- Assessing inherent risks, including fraud risks
 - SAS 109 and 99 require meeting of the audit team to communicate fraud risks and susceptibility to fraud.
- Preliminary assessment of control risk



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MATERIALITY

If not material, then we can "pass". But what is material?

An item is considered material if it would influence the decision of a reasonable user. Factors both qualitative as well as quantitative

QUANTITATIVE: If the amount is immaterial based on its numeric impact, general guidelines:

- 5% of net income (book says 5-10%- that's not my experience);
- .5 to 1% of sales/ assets
- 1% of total equity

QUALITATIVE: Think of it as possible ways to blow the above guidelines. Even if less than the above guidelines, if "qualitatively" it is material, then it is material. For instance:

- An error of 1% of net income. Less than the 5% guideline, but what if it would otherwise cause them to miss an earnings target? What if it would cause the company to blow a debt covenant?



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Assessing Fraud Risks

- Two types
 - Fraudulent financial reporting (management fraud)
 - Misappropriation of assets (defalcations)
- Procedures to assess fraud risks
 - Discussion among engagement team
 - Inquiries of management and other personnel
 - Planning analytical procedures
 - Considering fraud risk factors
 - Incentives
 - Opportunity
 - Attitude

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Assessing Fraud Risks—Identifying Fraud Risks

- Considerations in identifying fraud risks
 - Type
 - Significance
 - Likelihood that it will result in a material misstatement
 - Pervasiveness

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Responding to Fraud Risks

- Overall response
 - Professional skepticism and audit evidence
 - Assigning personnel and supervision
 - Accounting principles
 - Predictability of auditing procedures
- Alterations in audit procedures
 - More reliable evidence
 - Shifting timing to year end
 - Increasing sample sizes
- Response to the possibility of management override
 - Examining journal entries
 - Review accounting estimates for biases
 - Evaluating the business rationale for significant unusual transactions

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Consideration of Fraud Throughout the Audit

- Evaluating the results of audit tests
- Discovery of fraud
 - Communication to appropriate level of management
 - If fraud involves senior management or material misstatement communicate to audit committee

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Objectives of Substantive Programs for Asset Accounts

- Establish the *existence* of assets
- Establish that the company has *rights* to the assets
- Establish the *completeness* of recorded assets
- Determine the appropriate *valuation* of the assets
- Establish the *clerical accuracy* of the underlying records
- Determine the appropriate financial statement *presentation and disclosure* of the assets

Do y'all recognize this?

E,C,R,V,P- Management Assertions

The Audit Process

- Obtain an understanding of the client and its environment, including internal control
- Identify and assess inherent risks of material misstatement, including fraud risks
- Determine the planned assessed level of control risk and design additional tests of controls and planned substantive tests
- Perform additional tests of controls
- Reassess control risk and modify planned substantive tests
- Perform substantive tests and complete the audit
- Form an opinion and issue the audit report

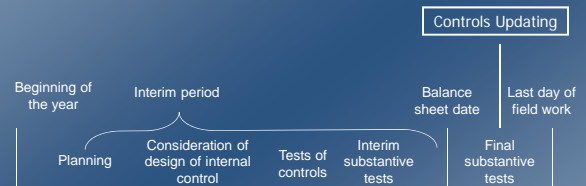
Summarized in the audit program guide "APG"

CAREFUL- IF AN IDENTIFIED RISK DOES NOT HAVE AN IMPACT TO THE FINANCIAL STATEMENTS, THEN FOCUSING UPON THAT FURTHER MAY CAUSE INEFFICIENCY

Relationship of Assertions, Objectives, and Procedures

| Management Assertions | General Audit Objectives for Assets | Specific Audit Objectives for Accounts Receivable | Example Audit Procedures |
|-----------------------------|--|---|--|
| Existence or occurrence | Existence of assets | All receivables exist | Confirm a sample of receivables by direct communication with debtors |
| Rights and obligations | Rights to assets | The client has rights to the receivables | Vouch a sample of recorded receivables to sales agreements |
| Completeness | Completeness of assets | All receivables are recorded | Compare a sample of shipping documents to related sales invoices |
| | Clerical accuracy of records | Receivables records are accurate and agree with general ledger | Obtain an aged trial balance of receivables, test it clerical accuracy, and reconcile to the ledgers |
| Valuation or allocation | Valuation of assets | Receivables are presented at net realizable value | Investigate the credit ratings for delinquent and large receivables accounts |
| Presentation and disclosure | Financial statement presentation of assets | Receivables are properly presented in the balance sheet, with appropriate disclosures | Perform procedures to identify receivables from related parties |

Overview of the Audit Process



New Engagement

NEED TO UNDERSTAND RISK OF NEW ENGAGEMENT

Required to discuss with "Predecessor" auditor:

- Reason for their termination
- Disagreements with management
- Other matters
- Management has to give the other firm a written authorization to discuss with "Successor" auditor.

Inquiries of bankers and lawyers

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New Engagement

Guess what- your new engagement inherently relies on the "opening balance sheet"

- Review predecessor workpapers
- Perform other procedures as deemed necessary

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Use of other auditors

Principal auditor can rely upon the report of another auditor, BUT:

- Must audit at least 50% of the assets, revenues, equity and income
- May need to make reference to the other auditors in your opinion if significant
- Ensure the other auditors are independent of the principal and related entities

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New auditor approval

For a public entity, the audit committee of the BOD appoints the auditors, pays their fees, etc... think about that, actually a pretty good impact from Sarbanes-Oxley Act.

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BOD: COMPOSITION

BOARD OF DIRECTORS MUST:
•Have 5 Financially Literate Members
•Have an audit committee

AUDIT COMMITTEE OF THE BOD:
•Comprised of at least 3 members of the BOD
•All members must be independent (other than their BOD role)
•Must be chaired by a Financial Expert

RESPONSIBILITIES:
•Approve appointment of auditors, including fees
•Oversee internal audit
•Required communications with auditors and resolve matters raised.
•Various others

NOTE: The above is REQUIRED of the BOD of a public registrant by SOX. It is a good idea for private companies to match as closely as possible.

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EXISTENCE- EZ, COMPLETENESS- NOT

Test the existence of a recorded asset or liability. Difficult to do?

NO- Just vouch to supporting documentation

COMPLETENESS. NOT SO EASY

In establishing completeness, are the auditors generally more concerned with assets or liabilities?

Liabilities- and unrecorded liability may indicate an unrecorded expense.

How do you test for a liability that has not been recorded?

Utilize Hindsight- "Search for Unrecorded Liabilities"

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