

CHAPTER THREE

Audit planning and audit program

The first standard of fieldwork states:

“The work is to be adequately planned, and assistants, if any, are to be properly supervised.”

The concept of adequate planning includes investigating a prospective client before deciding whether to accept the engagement, obtaining an understanding of the client’s business operations, and developing an overall strategy to organize, coordinate, and schedule the activities of the audit staff.

An audit plan is an overview of the engagement, outlining the nature and characteristics of the client’s

Business operations and the overall audit strategy

In planning the audit the auditor needs to consider the following:

1. The terms of the engagement and the expected date of the report.
2. The nature of the client’s business, include applicable statutory and contractual requirements.
3. The experience gained during previous audit engagements.
4. The accounting policies and degree of complexity of the accounting system.
5. Materiality and the components of audit risk.

The Need for Audit Planning

There are four main reasons why the auditor should properly plan engagements:

- To obtain sufficient appropriate evidence
- To help keep audit costs reasonable
 - ✓ Helps in ensuring appropriate attention is devoted to important areas of the audit.
 - ✓ Helps in ensuring that the audit work is completed expeditiously

- Helps the auditor to coordinate his work with those of other auditors, experts and internal auditors.
 - ✓ To avoid misunderstanding with the client
- To monitor the audit activities
 - ✓ Helps in identifying potential problems
 - ✓ Helps in utilizing assistants properly

There are five major parts of audit planning

- Preplanning
- Obtaining engagement
- Obtaining understanding of the client
- Developing an overall audit plan and strategies
- Designing audit program

(a) Preplanning/ Client acceptance

- The auditors should investigate the history of the prospective client, including such matters as the identities and reputations of the directors, officers, and major shareholders, its financial statements and audit report.

Sources of information

- Communication with predecessor auditors.
 - Make enquiries of other third parties (e.g. banker.)
 - Consult the client's legal counsel.
- Involves deciding whether to accept or continue doing the audit for the client and involves
 - Evaluating the client's reason for the audit
 - Selecting staff for the engagement
- Takes place early in the engagement

(b) Obtaining the engagement

- After the auditors have collected the necessary information on the potential client, they will be in a position to assess the various risk involved with the audit and determine whether to attempt to obtain

the engagement. Often they will be asked to submit a proposal which will include information on the nature of services that the firm will offer, the qualification of the firm's personnel, and other information to convince the prospective client to select the firm.

Fee arrangement: when the business engages the services of independent public accountant, it will usually ask for an estimate of the cost of the audit.

Engagement letter: The preliminary understandings with the client should be summarized by the auditors in an engagement letter, making clear the nature of the engagement, any limitations on the scope of the audit, work to be performed by the client's staff, schedule dates for performance and completion of examination, and the basis for computing the auditors' fee.

(c) Obtaining an understanding of the client's business.

- Extensive understanding of the client's business and industry and knowledge about the company's operations are essential.
- After the engagement is accepted, the auditors must obtain a detailed understanding of such factors as the client's financial position and operating results, organization structure, product lines, and methods of production and distribution. This will help auditors to evaluate the appropriateness of the accounting principles in use or the reasonableness of the many estimates and assumptions embodied in the client's financial statements.

(d) Developing an overall audit strategy

- After obtaining knowledge of the client's business, the auditor should formulate an overall audit strategy for the upcoming engagement. The best audit strategy is the approach that results in the most efficient audit.
- In planning an audit, the auditors must consider carefully the appropriate levels of materiality and audit risk.
- The auditor should plan to be able to conduct an effective audit in an efficient and timely manner.

Plans should be made to cover, among other things:

- Acquiring knowledge of the client
 - o Accounting systems
 - o Policies and internal control procedures
- Establishing the expected degree of reliance on internal control
- Determining and programming the nature, timing and extent of audit procedures to be performed
- Coordinating the work to be performed

(e) Designing audit programs

An audit program is a detailed list of audit procedures to be performed in the course of the examination. An audit program is designed to accomplish certain objectives with respect to each major account in the financial statements. These objectives follow directly from the assertions that are contained in the client's financial statements.

The Audit Program

- Lists audit procedures to be applied along with proper instructions
- Thus, contains:
 - o The description of specific audit procedures to be performed in respect of different aspects to be covered
 - o The extent to which the tests will be performed and the timing of such tests
 - o Lays down the responsibilities of various members of the audit team
 - o Sufficient details to serve as set of instructions to the audit staff and as a means to control proper execution.

AUDIT WORKING PAPERS

Working papers are records kept by the auditor of the procedures applied, the test performed, the information obtained, and the pertinent conclusions reached in the audit. For example, when samples are taken for audit tests, the items drawn must be recorded and computations must be made.

Objectives of audit working papers

- The overall objective of working papers is to aid the auditor in providing reasonable assurance that an adequate audit was conducted in accordance with generally accepted auditing standards.
- More specifically, working papers of a particular year's audit provide:
 - o A basis for planning and performance of the audit.
 - o A record of the evidence accumulated and the results of the tests
 - o Data for determining the proper type of audit report
 - o A basis for review by superiors
 - o Evidence that the audit was conducted in accordance with ISAs and legal and regulatory requirements
 - o Aid the auditors defense if subsequently sued for negligence

There are two major principles that need to be adhered to in preparation of working papers:

- If it is not recorded, it did not happen
 - o If there is nothing on file, there is no evidence that the necessary procedures were completed, so there can be no basis for the audit opinion.
- If it can't be understood, it might as well not have happened
 - o Clarity is important for two reasons
 - o Completeness – if the working papers are easy to understand it will be more obvious if anything has been omitted.
 - o Efficiency – clear working papers will keep the time spent and then the audit costs to a minimum.

In order to achieve the above objectives, the working papers should provide:

- A means of controlling the current year's work and the basis on which to plan the following year's audit;
- Evidence of the detailed work carried out and conclusions drawn on various sections of the work;

- Schedules and analysis in support of the accounts additional to, or summarizing, the details in the books of accounts;
- Summary of significant points affecting the financial statements and the audit report, showing how these points were dealt with;
- Information concerning the legal and organizational structure of the auditee.

Form and Contents of Audit Working Papers

Working papers may be of any form devised by the auditor but should so designed as to achieve the above objectives according to the auditor's own requirements and the particular circumstances of each audit. The working papers contain virtually everything involved in the examination and should be sufficiently complete and detailed.

In general, the form and contents of audit working papers are affected by:

- The terms of engagement
- The nature and complexity of auditee's business
- The nature and condition of records maintained
- The nature and condition of the internal controls in operation
- The needs of the particular circumstances for supervision and review of the work performed by audit assistants

Sometimes standard working papers are used. Such standard working papers help to instruct audit assistants and facilitate delegation of work while providing a means to control its quality. It is important to prepare the working papers properly at the outset and subject them to periodical reviews.

The purpose of audit working papers is not to make available a copy of the accounting records maintained by the client or substitute the client's accounting records. So, it is not necessary to include detailed information relating to transactions or account balances shown in the books of the client. Although the design depends on the objectives involved, working papers should possess certain characteristics:

- Each working paper should be properly identified with such information as the client's name, the period covered, a description of the contents, the initials of the preparer, the date of preparation and an index code.
- Working papers should be indexed and cross-referenced to aid in organizing and filing.
- Completed working papers must clearly indicate the audit work performed.
- Each working paper should include sufficient information to fulfill the objectives for which it is designed.
- The conclusion reached about the segment of the audit under consideration should be plainly stated.

In the case of recurring audits, it is usual to classify the working papers under permanent audit files and current audit files.

Permanent Audit Files

Permanent audit files contain information of continuing importance for succeeding audits and typically contain the following papers and documents:

- Extracts or copies of such company documents of continuing importance as articles and memorandums of association, by laws, and contracts.
- Analyses, from previous years, of accounts that have continuing importance to the auditor.
 - This includes accounts such as long term debt; stockholders equity accounts, goodwill, and fixed assets.
- A list of the client's advisors such as bankers, stock brokers, lawyers, insurance brokers etc
- Copies of letters where the client gives permanent instructions to the advisors stated above to supply the auditors with any information they request
- Copies of documents and minutes of continuing importance and relevance to the auditor like letter of engagement

- Information related to the evaluation of internal control
- The results of analytical review from previous years' audits
 - o Help the auditor decide whether there are unusual changes in the current year's account balances that should be further investigated

Analytical tests and internal control tests are included in the current period working papers by some audit firms.

Current Files

The current files include all working papers applicable to the year under audit. There is one set of permanent files for the client and a set of current files for each year's audit. Such files usually contain:

- Copies of the statements being audited or a working trial balance which is a listing of general ledger accounts and their year end balances
- An overall audit plan including an audit program containing:
 - o A list of work to be carried out by audit assistants
 - o A list with precise detail of the tests actually carried out
 - o The results of the tests and the conclusions drawn there from
 - o Cross reference from the internal control record and internal control letters
- A schedule for each item in the balance sheet, each schedule containing:
 - o The item at the beginning of the year, changes during the year, and the balance at the end of the year; and
 - o Details as to how the existence, ownership, value and appropriate disclosure have been verified

These schedules should be cross referenced to documents arising from external verifications such as bank letters, the result of circularization of debtors and creditors, attendance at stock taking etc.

- A schedule for each item in the profit and loss account, preferably including comparative figures
- A record showing full particulars of queries raised during the audit, coming forward from previous year, and their disposal together with notes, where appropriate for attention during the following year.
- Details of weaknesses in internal control discovered during the course of the audit of day to day transactions, the conclusion reached as to their nature and the action which has been taken
- Letters of representation, i.e., written by management to the auditors as confirmation of information given or opinion expressed in respect of matters such as the value of stock, amounts of current and contingent liabilities etc.

Ownership and Confidentiality of Working Papers

The working papers prepared during the engagement, including those prepared by the client for the auditor, are the property of the auditors and retained by them. The only time anyone else, including the client, has the right to examine the papers is when there is a court order to this effect.

The auditor obtains considerable amount of confidential information during the audit engagement, such information include officer salaries, product pricing and advertising plans, and product cost data. The auditor must, therefore, take the at most care to protect the working papers at all times.

Ordinarily, the working papers can be provided to someone else only with the express permission of the client. Permissions are not required when there is a court order or used as part of voluntary quality review programs with other audit firms.

Functions of working Papers

Audit working papers assist auditors in several major ways: they

- a) Provide a means of assigning and coordinating audit work;
- b) Aid seniors, managers, and partners in supervising and reviewing the work of assistants;

- c) Provide the support for the auditors' report;
- d) Document the auditors' compliance with GAAS; and
- e) Aid in planning and conducting future audits of the client.

Working papers normally include the audit plan and programs, documentation of the auditor's understanding of the internal control structure, the assessed level of control risk, account analyses explaining the composition of account balances, reconciliation of related records, letters of confirmation and representation, recommended journal entries if necessary to correct the accounts, and trial balances and other schedules that summarize the contents of other working papers.

Materiality and Audit risk

MATERIALITY

11. The Materiality Concept

In following generally accepted accounting principles, the accountant must consider the relative importance of any event, accounting procedure or change in procedure that affects items on the financial statements. The concept of materiality is relative. What is material for one firm may be immaterial for another firm. The determination of what is important and what is not requires the exercise of judgments. Precise criteria can't be formulated. Some factors do help to identify events as being material or immaterial. This is done by comparing the size and nature of an item or event with the size and nature of other events or items. For example, the erroneous classification of a Birr 10,000 asset on a balance sheet exhibiting total assets of Birr 100,000, however, if would certainly be material. If the Birr 10,000 represented a note receivable from an officer of the enterprise, it might well be material even in the first assumption.

The concept of materiality may be applied to procedures used in recording transactions. For example, small expenditures for plant assets may be treated as an expense of the period rather than as an asset. The saving in

clerical costs is justified if the practice does not materially affect the financial statements.

Information is material if its omission or misstatement could influence the economic decisions of reasonable users taken on the basis of the financial statements.

- The auditor's responsibility is to determine whether the financial statements are materially misstated
- Any material misstatements observed should be brought to the attention of the client for correction
- If the client refuses, issue a qualified report
- In applying materiality in practice, auditors must have knowledge of likely users of financial information users and the decisions they make on that basis

There are five closely related steps in applying materiality

1. Set preliminary estimate of materiality
2. Allocate preliminary estimate of materiality to segments
3. Estimate total error in segment
4. Estimate the combined error
5. Compare combined estimate to preliminary or revised estimate of materiality

Set preliminary estimate of materiality

- Ideally, early in the audit the auditor decides the combined amount of errors and irregularities in the financial statements that would be considered material
- The judgment treated as quantified and referred to as the preliminary estimate of materiality
- The preliminary estimate is the maximum amount by which the auditor believes the statements could be misstated and still not affect the decision of reasonable users

- The decision is very important and requires considerable professional judgment
- Setting of the estimate helps the auditor plan the appropriate evidence to accumulate
- If the auditor sets a low dollar amount, more evidence required than for a high dollar amount
- The preliminary estimate of materiality can be changed by the auditor during the audit
- The new estimate is called revised estimate of materiality

Factors affecting the estimate

The most important factors affecting setting of a preliminary estimate of materiality for a given set of financial statements are:

- Materiality is a relative rather than an absolute concept
 - An amount can be material for a small company but not for a bigger one
 - It is not possible to establish any dollar value guidelines applicable to all clients
- Bases are needed for evaluating materiality
 - Net income before tax is normally the most important basis as it is a critical item of information for the users
 - The effect of misstatements on reasonableness of other possible bases is also important. Such bases could be
 - Current assets
 - Total assets
 - Current liabilities
 - Owners' equity
- Qualitative factors
 - Amounts involving irregularities are usually considered more important than unintentional errors of equal dollar amount

- o Errors that are otherwise minor may be material if there are possible consequences arising from contractual obligations
 - o Errors that are otherwise immaterial may be material if they affect a trend in earnings
- Illustrative guideline
 - o Combined total errors or omissions exceeding 10% is normally considered material
 - o A combined total errors of 5% is presumed to be immaterial in the absence of qualitative factors
 - o Combined errors and irregularities between 5% and 10% require great amount of professional judgment to determine materiality
 - o Selecting the appropriate base
 - Income statement
 - Combined errors should be measured against operating income before tax
 - May be inappropriate in a year income is too large or too small
 - Balance sheet
 - Current assets, current liabilities – 5 to 10%
 - Total assets – 3 to 6%
 - o Qualitative factors should be carefully evaluated in all audits

Allocate preliminary estimate of materiality to segments

- This is necessary because evidence is accumulated by segments rather than for the financial statements as a whole.
- The preliminary estimate for each segment helps the auditor decide the appropriate audit evidence to accumulate
- Most practitioners allocate materiality to balance sheet rather than income statement accounts

- Most income statement errors have an equal effect on the balance sheet because of the double entry bookkeeping system
- When auditors allocate the preliminary estimate of materiality to account balances, the materiality allocated to any given account balance referred to as tolerable error
- An account is considered fairly stated if it is misstated by the amount of tolerable error or less
- Allocation of a preliminary estimate of materiality to segments is a difficult professional judgment
- Upon completion of the audit, the auditor must be confident that the combined errors in all accounts are less than or equal to overall estimated materiality

Estimate Error and Compare

- The first two steps of materiality involve planning whereas the last three result from performing audit tests
- When the auditor performs audit procedures for each segment, a record is kept of all errors found
 - o The estimated total error for each amount is shown – **step 3**
 - o Estimate of the combined errors is shown and it is the sum of the estimates for each account – **step 4**
 - o The estimate of the combined errors is compared with the preliminary estimate of materiality – **step 5**

Audit risk defined

The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, typically stating that the financial statements are true and fair when in fact they are not.

Audit risk: The term audit risk refers to the possibility that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated.

Audit risk can be further defined by the formula:

$$\text{Audit risk} = \text{Inherent risk} \times \text{Control risk} \times \text{Detection risk}$$

Inherent risk

The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

- The risk of errors or misstatements due to the nature of the company and its transactions.
- Requires good knowledge of client's activities

Control risk

The risk of errors or misstatements because the company's internal controls are not strong enough to prevent, detect and correct them.

- Is the function of the effectiveness of the design and operation of internal controls
- Some control risk will always exist because of inherent limitations of internal control
- Increases due to the lack of suitable procedures implemented by the client

Detection risk

The risk that the auditor's procedures do not pick up material misstatements either individually or when aggregated with other misstatements.

- Is a function of the effectiveness of an audit procedure and of its application by the auditor
- Cannot be reduced to zero due to sample test and other factors which could include:

- o Selection of inappropriate audit procedure
- o Misapply an appropriate audit procedure
- o Misinterpret an audit result

Assessing the risk

The audit risk comprises of three types of risk:

- Inherent risk (IR)
- Control risk (CR)
- Detection risk (DR)

And the formula to score the level of risk:

$$AR = IR * CR * DR$$

Inherent risk and control risk cannot be directly influenced by the auditor, as they relate to the nature of the entity and its systems. These two risks are known as the entity risk, together.

- The only risk the auditor can change is detection risk
- Detection risk is a major variable in determining the extent of audit procedures
- Once inherent and control risk are assessed and the maximum overall audit risk set, detection risk becomes the balancing figure

From the above formula, it is also true that:

$$DR = AR/IR * CR$$

Example:

- If the desired AR is 2%
- IR is 50%
- CR is 50%
- Detection risk is going to be

$$DR = 0.02/0.5 * 0.5 = 0.08 \text{ or } 8\%$$

Therefore, the auditor needs to accumulate audit evidence to the point at which there is an 8% risk of undiscovered error to satisfy the desired level of audit risk.