UNIT FIVE

PLANNING AND ANALYTICAL REVIEW PROCEDURES

Unit Objective

The main objectives of this unit are to acquaint students with auditing principles and tools. Therefore, after completing the unit, students are expected to:

- Explain the steps in audit planning and audit program
- Understand the benefit of documenting audit working paper

3.1 Audit Planning

The first Generally Accepted Auditing Standards of fieldwork requires adequate planning to be made before auditing is carried out. Reasons for proper audit plan includes

- To enable the auditor obtain sufficient competent evidence
- To help keep audit costs reasonable
- To avoid misunderstanding with the client

Obtaining sufficient competent evidence is essential if the CPA wants to minimize legal liability and maintain a good reputation in the business community keeping costs reasonable. It 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. The followings are the elements of audit planning:

1. Preplanning
2. Obtain background information
3. Obtain information about clients legal obligation
4. Perform preliminary analytical procedures

5. Set materiality, and assess acceptable audit risk and inherent risk
6. Understand internal control and assess control risk
7. Develop overall audit plan or audit program

As shown above, there are seven major parts of Audit planning. Each of the first six parts are intended to help the auditor develop the last part, an effective and efficient overall audit plan and audit program.

1. Preplan the Audit: Preplanning the audit involves four things, all of which should be done early in the audit.

- A decision whether to accept a new client or continue serving an existing one
- Identification of why the client needs an audit
- Obtaining an understanding with the client about the terms of engagement to avoid misunderstandings.
- Select staff for engagement

Investigation of new client and re-evaluation of existing ones is important to assess the integrity of the client and to assess the acceptable financial risk it will assume. If the CPA firm decides that acceptable risk is extremely low, it may choose not to accept the engagement. If the CPA firm concludes that acceptable audit risk is low but the client is still acceptable, it is likely to affect result and the fee proposed to the client, Audits with low acceptable audit risk will normally result in higher audit costs, which should be reflected in higher audit fees.

Obtaining an understanding with the client is expressed by the use of engagement letter, even though it is not required. Engagement letter is an agreement between the CPA firm and the client for the conduct of the audit and related services. It should specify whether the auditor will perform an audit, a review, or a compilation, plus any other service such as tax returns or management consulting. It should also state any restriction to be

provided for the audit, an agreement on fees. The engagement letter is also a means of informing the client that the auditor cannot guarantee that all acts of fraud will be discovered. Selection of staff for engagement involves the assignment of appropriate staff to the engagement if the CPA firm decides to accept the client and conduct the audit. Selection of audit staff is important to meet the first requirement of generally accepted auditing standard and to promote audit efficiency. The first GAAS stats “that the audit is performed by a person or persons having adequate technical training and proficiency as an auditor”.

2. Obtain Background Information: An extensive understanding of the client business and industry and knowledge about the company’s operation are essential for doing adequate audit. There are three reasons for obtaining a good understanding of the clients industry. First, many industries have unique accounting requirement that the auditor must understand to evaluate whether the clients financial statement are in accordance with GAAP. Second, auditors can often identify risks that may affect the auditor’s assessment of acceptable audit risk, or even whether auditing companies in the industry is advisable.

Finally, there are inherent risks that are typically common to all clients in certain industry. Understanding those risks aids the auditor in identifying the client’s inherent risk. Knowledge of the clients industry can be obtained in different ways. These include:

- Discussion with previous auditor
- Discussion with clients personnel
- Tour the plant and office of the clients
- Discussion with outside specialists.

3. Obtain Information about Client’s Legal Documents: Early knowledge of the legal documents and records enables auditors to interpret

related evidence throughout the engagement and to make sure there is proper disclosure in the financial statement. Three closely related types of legal documents and records should be examined early in the engagement.

- **The Corporate Charter and the Bylaws:** The corporate charter is granted by the state in which the company is incorporated and is the legal document necessary for recognizing a corporation as a separate entity. It includes the exact name of the corporation, the date of incorporation, the kind and amount of capital stock the corporation is authorized to issue and the types of business activities the corporation is authorized to conduct. The bylaw includes the rules and procedures adopted by stockholders of the corporation; they specify such things as the fiscal year of the corporation, the frequency of stockholders meetings, and the methods of voting for directors, and the duties and power of the corporate offices.

- **The Corporate Minutes**: are the official records of the meetings of the boards of directors and stockholders. They include summaries of the most important decision made by the directors and stockholders. The auditors should read the minute to obtain information that is relevant to perform the audit including the authorization and discussion by the board of directors affecting inherent risk.

- **Contracts**: clients involved in different types of contracts that are interested to the auditors. These can include various items such as long term notes and bonds payable, stock option, pension plan, contracts of manufactured products, contracts with vendors for future deliveries of supplies, government contacts and leas.

4. Performing Preliminary Analytical Procedures: Auditors are required to perform analytical procedures while planning the audit to assist the auditor in determining the nature, timing and extent of auditing procedures. Analytical procedures made during the planning phase enhance the auditors understanding of the client's business and events occurring since the prior year's audit. Planning analytical procedures also help the auditor identify areas that may represent specific risks of material misstatement warranting further attention.

5. Understand internal control and assess control risk (This would be discussed in detail in unit four)

6. Develop an Over All Audit Plan

The last step in the planning the audit is to develop an over all strategy. This involve about the nature, extent, and timing of audit test to be conducted. The audit strategy is normally documented in an audit plan and audit program containing specific audit procedures. The audit program for most audits is designed in three parts:

1. Test of transactions
2. Analytical procedures
3. Test of details of balance

3.2 Audit Program

An audit program is a set of policies and procedures that dictate how auditing is to be implemented. It usually involves audit software as well as internal work that are manually performed by an auditor. These measures are generally employed to determine what, and how much, evidence must be collected and evaluated — as well as who will collect and evaluate it, and when this should be done.

Organizations typically prepare audit programs based on the operational planning activities of the evidence collected and evaluated by an auditor. Audit program is prepared and, if need be, revised in accordance with this evidence. It is documented in the *audit working papers*, which are the official record that contains the planning and execution of the audit agreement. While the formality of an audit program largely depends on the size of the organization, all programs require certain elements in order to be effective.

The audit program establishes the procedures necessary to complete an efficient and effective audit. It includes a detailed plan of the work to be performed as well as the steps required to achieve the audit objectives. There should be sufficient detail for less experienced staff to perform the steps, however, it should not be overly detailed whereby it might cause auditors to execute steps routinely and override their judgment.

A well designed audit program provides an outline of the work to be performed encouraging a thorough understanding of the unit audited. It acts as a guide for assigning work and thereby controlling the project from beginning to end. It creates documentation and evidence that the work was completed. It assists management review to ensure quality. It assures management that all risk areas were adequately addressed.

Areas that should be covered by the audit program include the audit objectives, test procedures, sample size, sample selection, time period, reports for sample selections, and reports and documents subject for review as well as attributes for testing.

The program should be prepared before the beginning of the fieldwork and approved by audit management. Audit programs are not set in stone and therefore modified during the course of the audit depending on test results

or new information obtained. However any changes to the audit program or procedures should be reviewed and approved.

Risk assessment is one of the most critical components of an audit program. Through this process, risks for specific areas of the business are identified and analyzed. Auditors are encouraged to conduct risk assessment on a consistent basis to keep pace with changes to internal control and various work processes. An organization's level of risk is considered a key aspect in determining how often audits should be performed.

An effective audit program also includes an audit cycle, which simply refers to the frequency of audits. As mentioned above, this frequency is normally determined by conducting risk assessment. There are some factors that could impact the audit cycle, mainly time and audit staff. Even with this knowledge, it is advisable for organizations to not allow such factors to reduce the periods, at which audits are performed, especially for areas susceptible to great risk. Doing so could leave the organization vulnerable to substantial risks that have yet to be identified.

Another essential component of an audit program is audit planning. Although strategies are generally devised with respect to individual organizations, a well-rounded plan is often viewed as one that covers scheduling, audit staff needs, reporting, and the overall goals of the audit. Many organizations find that this planning is most efficient when the results of risk assessment are combined with the resources needed to determine the timing and frequency of audits.

1.3. Auditor’s Working Paper

Working papers are the records kept by the auditor of the procedures applied, the test performance, the information obtained and the pertinent conclusions reached in the engagement. The over all objectives

of working paper are to aid the auditor in providing reasonable assurance that an adequate audit was conducted in accordance with GAAS. The working papers as they pertains to the current years has the following purpose

- Provide a base for planning the audit, because the working papers describe information about internal control structure, a time budget for individual audit areas, the audit program and the results of the preceding year's audit.
- A record of the evidence accumulated and the result of the test
- Data for determining the proper type of audit
- Basis for review by supervisor and partner. The working papers are the primary frame of reference used by supervisory personal to evaluate weather sufficient competent evidence was accumulated to justify audit reports.

Working papers contain virtually every thing involved in the examination. The filling of working paper is classified in to the following.

1. **Permanent Files:** are intended to contain data of a historical or continuing nature pertinent to the current examination. The permanent files typically include the following.

- Extracts or copies such as articles of in corporation, by laws and contracts.
- Analysis from previous years of accounts that have continuing importance to the auditor such as long term debt, stock holders equality accounts, good will and fixed asset.
- Information related to the understanding of the internal control structure and assessment of control risks such as organization charts, flowcharts questioners etc.
- Result of analytical procedures from previous year's audit such as ratio and percentage computed by the auditor.
- Total balance for selected accounts.

- Others

2**. Current Files**: The current files include all working papers applicable to the years under audit. The types of information included in the current file are:

- Audit program
- General information like planning memos, copies of minutes, agreements notes on discussion with client etc.
- Working trial balance, listing of the general ledger account and their year end balance including subsidiary balance and account.
- Adjusting and reclassification entries
- Supporting schedule such as analysis of account trail balance, reconciliation of amounts, test of reasonableness, summary of procedures, examination of supporting documents, outside documentation.
- Others

The working paper prepared during the engagement, including those prepared by the client for the auditor are the property of the auditor. The only time any one including the client has legal right to examine the paper is, when they are subpoenaed by the court as legal evidence. At the completion of the engagement, working paper is kept at the auditors premise for future reference. The working paper can be provided to some one else with expressed permission of the client.

3.4 Audit Risk Assessment and Materiality

Audit risk represent the risk that the auditor will conclude that financial statement are fairly stated and unqualified opinion can be issued when in fact they are misstated. Audit risk refers to the possibility that the auditor may unknowingly fail to appropriately modify their opinion on financial statement that is materially misstated. Audit risks are divided in to four:

a) Inherent Risk

b) Control Risk
c) Detection Risk
d) Acceptable Audit Risk

a. Inherent Risks: is a measure of the sensitivity or susceptibility of the financial statement account to material misstatement before considering the effectiveness of internal control, accounting controls, policies or procedures. Internal control is ignored in setting inherent risk because they are considered separately in audit risk assessment as control risk.

b. Control Risk: is the risk that a material misstatement will not be prevented or detected on timely basis by the clients internal control structure. Control risk represent an assessment of whether clients internal control structure is effective for prevention or detecting error and the more effective the internal control, the lower the control risk

c. Detection Risk: is the audit risk that the auditor will fail to detect material misstatement with their audit procedures. It is the possibility that audit procedures will lead them to conclude that a material misstatement does not exist in an account, in fact such misstatement does exist. Detection risk is a function of the procedures auditors perform for testing assertions.

d. Acceptable Audit Risk: is the measure of how willing the auditor is to accept that the financial statement may be martially misstated after the audit is completed and unqualified opinion has been issued. When the auditor decides on lower acceptable risk, the auditor wants to be more certain that the financial statement will not materially misstated. Zero acceptable risk would be high certainty and 100% acceptable audit risk would be complete uncertainty. The primary way that the auditors deal with risk in planning audit evidence is through the application of the audit risk model. The audit risk model is used primarily for planning purpose in deciding how much evidence to accumulate in each cycle.

Unit Summery

- Audit procedures are steps of actions taken in process for verification or accomplishing a specific audit objective. Audit techniques are any techniques used by the auditor to determine deviation from actual deviations.
- Audit approaches are point of view or attitude of the auditor which influence the processes and techniques adapted for circumstances
- Management assertions are expressed or implied representations by the management that are reflected in the financial statement.
- Audit objectives are objectives set by the auditor to test managements assertions
- The auditor should properly plan its auditing activities in order to accomplish the audit on the specified date. This planning involves seven steps.
- Working papers are the records kept by the auditor of the procedures applied, the tests performance, the information obtained, the conclusions reached in the engagement.