



Unit No: 2
Planning and risk
assessment

Professional ethics and the new audit engagements



- ⌘ Auditors may advertise their services.
- ⌘ Adverts should not bring the ACCA into disrepute, discredit the services of others, be misleading, or fall short of regulatory or legislative requirements.
- ⌘ An auditor is required under ISA 315 to gain an understanding of their client.
- ⌘ Auditors should screen clients to ensure they are not high risk.

Preconditions For Audit



- ☞ Use by management of an acceptable financial reporting framework in the preparation of the financial report.
- ☞ Agreement of management is charged with governance to the premise on which an audit is conducted.
- ☞ Auditors should accept a new audit engagement.
- ☞ Continue with an existing audit engagement if the 'preconditions for an audit' agreeing the terms are already present.
- ☞ ISA 210 requires auditor to determine whether appropriate financial reporting framework is applied in the preparation of financial statements

Procedures For Audit



- ☞ Ask client for permission to contact ongoing auditor.
- ☞ Ensure legal requirements in relation to removal of previous auditors and appointment of the firm have been met.
- ☞ Carry out checks to ensure firm can be independent, competent to do this audit and possess necessary resources.
- ☞ Assess whether this work is suitably low risk.
- ☞ Assess the integrity of company's directors.
- ☞ Firm should also ensure that this is a desirable client. Eg., **Right industry, suitable profit margin.**
- ☞ Not accept the appointment, where it is known that a limitation will be placed on the scope of audit.

New Engagement Process



- ☞ The client should be asked for permission to contact the outgoing auditor. (If not given— refuse the position).
- ☞ Contact the outgoing auditor to ask if there is any professional reason not to take the role.
- ☞ Ensure process of appointment and resignation of previous auditor was carried out correctly.
- ☞ Check we are sufficiently Independent
- ☞ Ensure that the audit firm is properly qualified to act for the client (Legality / Ethics).
- ☞ Undertake risk assessment of the firm.

New Engagement Process (Cont'd...)



- ☞ Ensure that the audit firm has adequate resources to conduct the audit.
- ☞ Consider size of client, business area etc and how this will affect the audit.
- ☞ What level of fees will be provided – is it worth it?
- ☞ Does it make up more fees % than allowed?

Obtaining Audit Engagements



- ☞ Purpose of International Standard on Auditing (ISA) is to establish standards and guidance on:
 - a. Agreeing the terms of engagement with the client.
 - b. The auditor's response to a request by a client to change the terms of engagement.
- ☞ Auditor and client should agree on terms of engagement.
- ☞ ISA is intended to assist auditor in preparation of engagement letters relating to audits of financial statements.
- ☞ Objective and scope of an audit and auditor's obligations are established by law

Audit Engagement Letter



☞ An engagement letter is a letter from the auditor to the client indicating various matters concerning the engagement.

☞ The engagement letter is sent before the audit to the client confirming their acceptance of the audit.

Contents of Audit Engagement Letter



ISA 210 Terms of Engagement gives guidance as to their content, but as a rule most will include:

- ☞ The Objective of the audit.
- ☞ Managements' responsibility for the Financial Statements.
- ☞ The scope of the audit including reference to legislation and professional standards.
- ☞ The form of report to be used
- ☞ Use of the work of internal audit

Contents of Audit Engagement Letter (Cont'd...)



ISA 210 Terms of Engagement gives guidance as to their content, but as a rule most will include:

- ☞ Reference to inherent limitations of an audit
- ☞ Access to information to be allowed
- ☞ Deadlines and confidentiality
- ☞ Expectations of management representations
- ☞ Fees
- ☞ Complaints procedures

Explain the quality control procedures that should be in place over engagement performance, monitoring quality and compliance with ethical requirements



☞ **Engagement partner:** The partner responsible for the audit engagement, performance and report. Also she has the appropriate authority from a professional, legal or regulatory body.

☞ **Engagement Quality Control Review:** Provides an objective evaluation, before signing the report, of any significant judgments & conclusions. It is for listed entity audits and any where the firm thinks such a review is required.

Explain the quality control procedures that should be in place over engagement performance, monitoring quality and compliance with ethical requirements (Cont'd...)



☞ **Engagement Quality Control Reviewer:** Someone not part of the engagement team, with experience and authority to objectively evaluate the significant judgments & conclusions

☞ **Engagement team:** All partners and staff performing the engagement, plus anyone engaged by to do audit work. This excludes external experts.

☞ **Firm:** A sole practitioner, partnership or corporation of professional accountants.

Explain the quality control procedures that should be in place over engagement performance, monitoring quality and compliance with ethical requirements



☞ **Inspection:** These provide evidence of compliance with the firm's quality control policies

☞ **Listed entity:** An entity whose shares (or debt) are quoted on a stock exchange

☞ **Monitoring:** An ongoing evaluation of the firm's quality control. It includes periodic inspections of a selection of completed engagements

Standards on Quality Control



1. At the FIRM level International Standard on Quality Control 1 (ISQC 1) – Quality Control for firms that perform audits and reviews.
2. At the individual AUDIT level ISA 220 – Quality Control for audits of historical financial information.

Levels of International Standards on Quality Control



ISQC 1 Identifies six building blocks of a firm's system of quality control:

- ☞ Ethics
- ☞ Client Relationships
- ☞ Leadership
- ☞ Human Resources
- ☞ Engagement Performance
- ☞ Monitoring

Firm Level Quality Control



The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:

- a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

1. Leadership

- ☞ An internal culture focused on quality is key.
- ☞ This means training, appraisal & mission statements.
- ☞ Commercial considerations never override quality.
- ☞ Pay & Benefits must reflect commitment to quality.
- ☞ Resources must be available to support quality.

Firm Level Quality Control (Cont'd...)



2. Human Resources

- ☞ All staff to have the capabilities & competence to ensure quality.
- ☞ Appraisals and development regularly

3. Engagement Issues – Planning

- ☞ Discuss known risks with the client and document.
- ☞ Staff suitably qualified and experienced, have knowledge of the client.
- ☞ Contentious areas must be consulted on in a cost effective way.
- ☞ A timetable for suitable reviews.
- ☞ Ensure independence and any issues addressed.
- ☞ Time pressure.

Firm Level Quality Control (Cont'd...)



4. Engagement Issues - Supervision

- ☞ Staff supervised and assessed to control the work flow.
- ☞ Any problems tackled immediately and consultation on any deviations from the original plan.

5. Engagement Issues – Review

- ☞ Review has the purpose of identifying previously unrecognized problems and examining the rest of the work carried out.
- ☞ Is the amount of evidence gathered sufficient or is further work required?

Quality control can be achieved during the review stage by:

- 1) Learn lessons from mistakes made.
- 2) Appraisal staff immediately after assignments to praise &/or constructively criticize.

Firm Level Quality Control (Cont'd...)



6. Monitoring

- ☞ Ensure new developments in standards and regulations are implemented and CPD is kept up to date.
- ☞ Any breaches to monitoring system dealt with.

7. Ethical Requirements

- ☞ Have procedures to comply with ethical requirements eg. Independence.
- ☞ Emphasize through leadership, education/training, monitoring and dealing with non-compliance.
- ☞ Have procedures to identify independence threats eg. prompt notification by employees.
- ☞ Ensure that firm is notified of breaches of ethical requirements promptly.

Direction, Supervision and Performance



1. Directing the engagement team includes:

- ☞ Their ethical responsibilities.
- ☞ Their need to plan and perform an audit with professional skepticism.
- ☞ The objectives of the work to be performed.
- ☞ The nature of the entity's business.
- ☞ Risk-related issues.
- ☞ Problems that may arise.
- ☞ The detailed approach to the performance of the engagement.

Direction, Supervision and Performance (Cont'd....)



2. Supervision includes:

- ☞ Seeing if the team has enough time and competence to do their job and understand their instructions.
- ☞ Addressing significant matters arising during the audit and modifying the plan appropriately.
- ☞ Identifying matters for consultation with experienced engagement team members.

3. Reviews include:

- ☞ Ensuring that work of less experienced team members is reviewed by more experienced ones.
- ☞ Appropriate consultations have happened.
- ☞ The work performed supports the conclusions reached and is appropriately documented.

Engagement Quality Control Review



- ☞ It helps to see if sufficient appropriate evidence has been obtained.
- ☞ It is done throughout the audit so significant matters are promptly resolved before the date of the auditor's report.
- ☞ Documentation of the review may be completed after the auditor's report (as part of the assembly of the final audit file)

The extent of the review depends on:

- 1) The complexity of the audit.
- 2) If the entity is listed, and
- 3) The risk of an inappropriate auditor's report.

ISA 220 Quality Control for Audits of Historical Financial Information



1. Client acceptance procedures:

- ☞ There should be full documentation, and conclusion on, ethical and client acceptance issues in each audit assignment.
- ☞ Engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the team are independent of the client.
- ☞ Engagement partner should conclude whether all acceptance procedures have been followed, for example, that the audit firm has considered the integrity of the principal owners and key management of the client.

ISA 220 Quality Control for Audits of Historical Financial Information (Cont'd....)



- œ Obtaining professional clearance from previous auditors
Consideration of any conflict of interest.
- œ Money laundering (client identification) procedures.
- œ Establish the identity of the entity and its business activity e.g. by obtaining a certificate of incorporation.
- œ If client is an individual, obtain official documentation including a name and address, e.g. by looking at photographic identification such as passports and driving licenses.
- œ Consider whether the commercial activity makes business sense (i.e. it is not just a 'front' for illegal activities).
- œ Obtain evidence of the company's registered address e.g. by obtaining headed letter paper.
- œ Establish the current list of principal shareholders and directors.

Objectives of Auditor



- ☞ **ISA 200** says “to obtain reasonable assurance, the auditor shall obtain sufficient appropriate evidence to reduce audit risk to an acceptably low level”.
- ☞ **ISA 315** extends this “to identify and assess the risk of material misstatement...designing and implementing responses to the assessed risks of misstatement”.
- ☞ **ISA 450** Evaluation of Misstatements Identified During the Audit states that this occurs when something in the accounts is not in accordance with the applicable financial reporting framework. They can arise from error or fraud.

There are 3 categories:

- ☞ **Factual Misstatements:** Those where there is no doubt.
- ☞ **Judgmental misstatements:** Those where the managements judgements on estimates not considered reasonable or the policies are inappropriate.
- ☞ **Projected misstatements:** These come from extrapolating misstatements in samples across a population.

Components of Audit Risk



- ∞ Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
- ∞ Stated another way, this is the risk that there is a material misstatement in the financial statements, but the auditor misses it and says that they present a true and fair view.

Formula for audit risk is:

Inherent Risk x Control Risk x Detection Risk

Inherent Risk



Inherent Risk: This will be considered at the planning meeting as it depends on the auditors' knowledge of the business. Examples are:

☞ **A cash based business:** This is often a problem as there must be very strong controls in place if a business is a cash based one. The auditor may feel that there are insufficient controls in place to mitigate this risk which may lead to limitation of scope.

☞ **Fast moving Industry:** In fast moving industries such as IT or fashion there may be a risk that the inventory held by the business becomes obsolete.

☞ The auditor may take expert advice on the valuation of inventory, or they may review post year-end sales to ensure the goods are sold for more than they are valued at in the financial statements.

Control Risk



Control Risk: This is risk of material misstatement due to inadequate internal controls within the business. The auditor will make a judgement as to the suitability and strength of internal controls. Examples are:

Segregation of Duties: Segregation of duties is where different tasks in a process are performed by different people e.g. an invoice is raised by one person and the cheque is written by another and authorize by someone else.

No controls over access to assets: If employees have unfettered access to the assets of the business with no restrictions, this will increase the risk of theft or damage to those assets. If the auditor finds this to be the case, more physical checks of the existence and condition of assets will have to be carried out.

Detection Risk



Detection Risk: This is the risk that the work carried out by the auditor does not uncover a material misstatement that exists. Detection risk can be split into sampling & non-sampling risk. Detection risk may be increased by things such as inexperienced audit staff or tight deadlines to complete the audit.

⌘ **Non-sampling risks:** The auditor did not sufficiently investigate a significant balance. The procedures used may have been inappropriate or misinterpreted.

⌘ **Sampling risk:** Arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure. This is another way of saying that the sample selected by the auditor was not representative of the data.

Examples of Audit Risks



Other examples of audit risks include:

- ❧ **Treatment of capital and revenue expenditure** – The risk here could relate to existence of property plant and equipment if revenue expenditure has been capitalized rather than charged as an expense in the income statement.
- ❧ **Valuation of inventory** – When, for example, there are considerable levels of aged inventory
- ❧ **Completeness of liabilities** – This could arise if provisions have been incorrectly treated as contingent liabilities
- ❧ **Completeness of revenue** – This could be relevant where the entity being audited has significant cash sales.

Concept of Materiality



- ☞ ISA 320 defines information as material if ‘its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’
- ☞ Material items could be large transactions or significant events.
- ☞ Materiality is important to the auditor because if a material item is incorrect, the financial statements will not show a ‘true and fair view.’

Material Levels



∞ Materiality Levels: The auditor will decide materiality levels and design their audit procedures to ensure that the risk of material misstatements is reduced to an acceptable level. Generally, materiality will be set with reference to the financial statements such as:

0.5 – 1% of turnover

5 – 10% of profits reported

1 – 2 % of gross assets

Judgement will be used by the auditor in charge and will depend on the type of business and the risks it faces.

∞ Considerations:

Quantity: The relative size of the item.

Quality: This might be something that's low in value but could still affect users' decisions E.g.: Directors wages.

How to get initial understanding



Firstly the auditor needs to understand the entity's environment, this will require the auditor to assess the following:

- ☞ Industry conditions
- ☞ Principle business strategies
- ☞ Competitors
- ☞ Laws and regulations
- ☞ Technology
- ☞ Stakeholders
- ☞ Financing
- ☞ Acquisitions and disposals
- ☞ Related parties
- ☞ Competence of management
- ☞ Accounting policies

How to get initial understanding? (Cont'd...)



- ☞ **ISA 315** requires a planning meeting where ‘the members of the engagement team should discuss the susceptibility of the entity’s financial statements to material misstatements.
- ☞ The minutes of this meeting should be documented as evidence of its occurrence.
- ☞ Analytical procedures should be undertaken at this stage to establish an understanding of the financial statements and draw attention to anomalies.

Risk Assessment Procedures

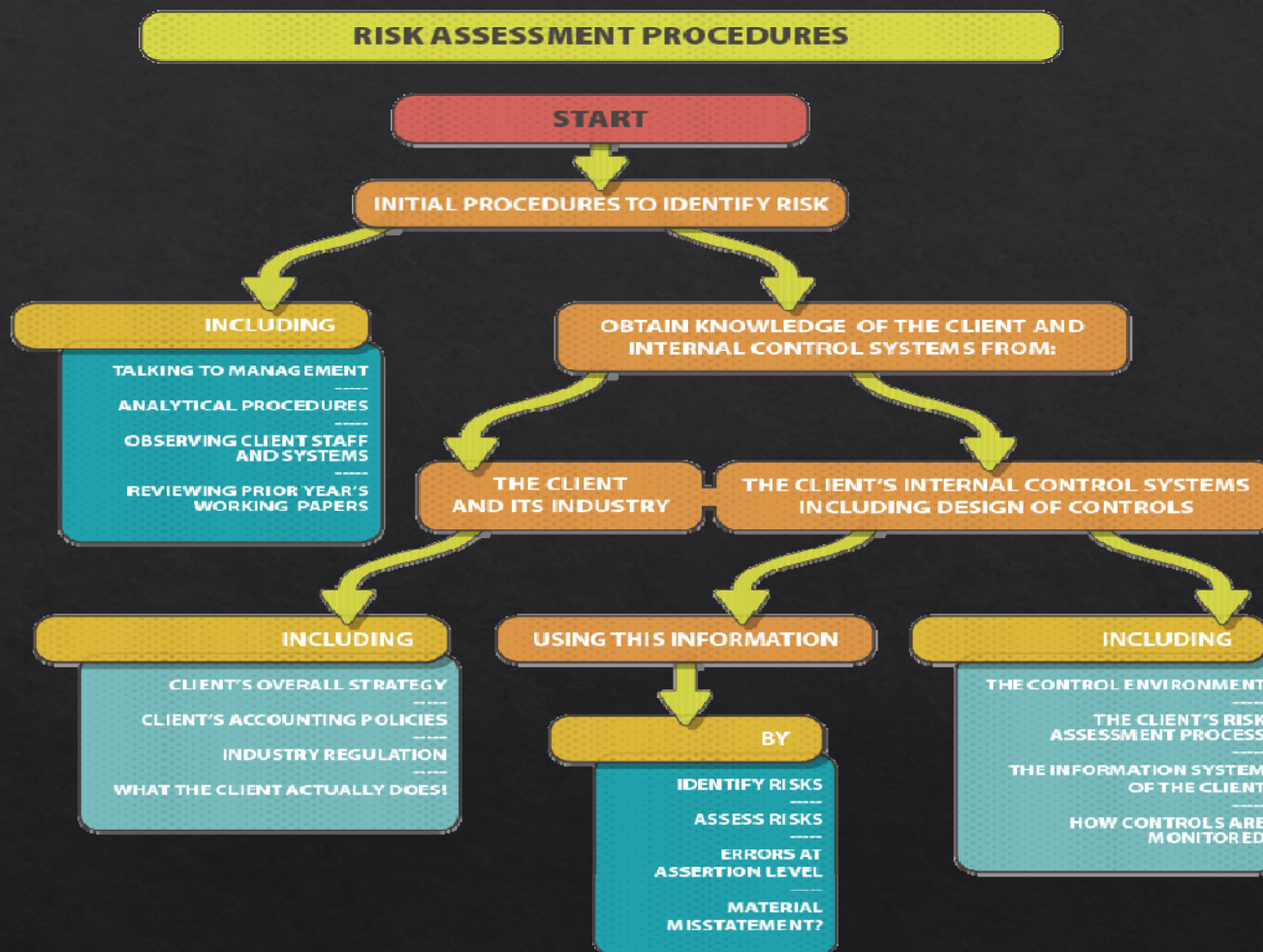


- ⌘ **The nature of the company**
- ⌘ **What's the company's market overview?** For example, if the client is a bank, in how many countries does it operate?
- ⌘ **Who (if anyone) regulates the client?** Many businesses don't have an outside regulatory agency, but any publicly traded company will have stock exchange rules to follow.
- ⌘ **What's the company's business strategy?** Most business strategies are to maximize shareholder value by increasing profitability and serving the community in which they're located.

Risk Assessment Procedures (Cont'd...)



- ☞ The quality of company management.
- ☞ Check their attitude in interviews.
- ☞ Is there high employment turnover.
- ☞ Are the top management experienced
- ☞ Any accounting adjustments needed in prior years
- ☞ Ask Employees for information
- ☞ Talk with individuals holding different levels of authority, from low-level clerks all the way up to the board of directors.



Analytical Procedures in Planning



- ☞ Analytical procedures are compulsory at two stages of the audit under **ISA 520** namely the **planning stage** and the **review stage**.
- ☞ Analytical procedures use calculations such as financial ratios to generate an expectation of what a figure is likely to be and then comparing this to the actual figure in the accounts.
- ☞ They can be used to highlight unusual figures in order to focus the audit on them or to establish that a trend has continued.
- ☞ At the planning stage they help you understand the business and its environment.
- ☞ Because you compare figures to the industry and to previous years.
- ☞ Any items which go against the expected relationships help you assess the risk of material misstatement.

Steps to perform analytical Procedures



A step by step guide:-

1. Predict a figure, based on a relationship. Eg. This could be gross profit as a % of revenue (based on previous years and industry averages).
2. Define what a significant difference is. We call this the threshold below which we see any difference as just a tolerable 'error'.
3. Calculate the procedure and the difference to the prediction in step 1.
4. Investigate the difference: Differences indicate an increased likelihood of misstatements.

If caused by factors previously overlooked, look at what impact this would have on the original expectations as if this data had been considered in the first place, and to understand any accounting or auditing ramifications of the new data.

Types of Analytical Procedures



Trend analysis: The analysis of changes in an account over time.

Ratio analysis: The comparison of relationships using financial and non-financial data.

Reasonableness testing: Comparing expectations based on financial data, non-financial data, or both to actual results.

Key Ratio's used in Analytical procedures



The financial ratios used by the auditor will fall into 3 general categories:

1. Profitability/Return:

- a) Gross Margin.
- b) Net Margin.
- c) ROCE.

2. Liquidity/Efficiency:

- a) Receivables/Payables/Inventory Days.
- b) Current Ratio.
- c) Quick Ratio.

3. Gearing:

- a) Financial Gearing.
- b) Operational Gearing.

Formula's



ROCE

Profit Before Interest and Tax

Total Assets – Current Liabilities (Capital Employed)

ROE

Profit after tax – preference dividends

Equity shareholders funds

Gross Margin

Gross profit

Revenue

Operating Margin

Profit before interest and tax

Revenue



Formula's (Cont'd...)

Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Quick Ratio

$$\frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

Inventory Days

$$\frac{\text{Closing (or average) Inventory}}{\text{COS}} \times 365$$

Receivable Days

$$\frac{\text{Trade Receivables}}{\text{Credit Sales}} \times 365$$



Formula's (Cont'd...)

Payable Days

$$\frac{\text{Trade Payables}}{\text{Credit Purchases}} \times 365$$

Gearing

$$\frac{\text{Debt}}{\text{Debt + Equity}} \text{ OR } \frac{\text{Debt}}{\text{Equity}}$$

Interest Cover

$$\frac{\text{Profit before Interest and Tax (PBIT)}}{\text{Interest payable}}$$

Fraud, Error and Irregularity



Fraud: An intentional act involving the use of deception to obtain an unjust or illegal advantage. Three main areas of fraud exist:

a) Corruption; b) Misappropriation of assets; c) Financial statement fraud.

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure. Examples are:

a) A mistake in gathering data from which FS are prepared

b) An incorrect accounting estimate due to an oversight

c) A mistake in applying accounting principles

Irregularity: An intentional misstatement to mislead users. If a material error is identified, but not corrected it becomes an irregularity.

Importance / Need of Audit Planning



- ☞ Planning and performance of auditing.
- ☞ Acknowledging receipt of engagement letter.
- ☞ Basis on which fees are computed and any billing arrangements.
- ☞ Arrangement of other auditors and experts in some aspects of audit.
- ☞ Reference to any further agreements between the auditor and client.
- ☞ Agreement of management to inform auditor of facts that may affect financial statements.

Management Responsibilities



These are:

- ☞ Safeguards created to avoid fraud and error using internal controls.
- ☞ Internal audit is responsible for monitoring and implementing these.

Auditor's Responsibilities



- ☞ If fraud or error leads to a material misstatement, the auditor is responsible for detecting it.
- ☞ If immaterial, these should be reported to those charged with governance, but there is no responsibility to detect them.
- ☞ The inherent limitations of audit mean that the auditor cannot guarantee that the financial statements are free from fraud and error.
- ☞ At the Planning Stage: The auditor must consider the risk of material misstatement due to fraud and error when planning and performing their audit.
- ☞ If fraud is discovered report it to the audit committee or
- ☞ Highest level of management (if not involved in the fraud), or
- ☞ Shareholders if the fraud is by those in senior management.

Contents of Audit Plan



- ☞ Ensure understanding of the business.
- ☞ Undertake analytical review.
- ☞ Assess the risks involved with the business.
- ☞ Establish materiality levels.
- ☞ Establish tolerable error for material errors.
- ☞ Decide the audit approach.
- ☞ Ensure auditor independence.
- ☞ Decide the budget and staff requirements.
- ☞ Timetable the audit & set deadlines

Interim Audit vs Final Audit



Interim Audits: Basically before the Year-end, allowing procedures to be more spread out and improve planning of the final audit. It should improve risk assessment and make the final procedures more efficient. It will help with levels of materiality and allow final audit to concentrate on year end valuations and matters of significant subjectivity.

The interim audit will normally be used for:

- Documenting the system
- Evaluating controls
- Testing specific transactions (e.g. big NCA purchase)
- Interim receivables circular

Interim Audit vs Final Audit (Cont'd...)



Timings:

Early enough - so not interfering with Y/E client work

Late enough - to give adequate warning of specific problems that will need to be addressed

Final Audit:

Post year-end, focus on year end valuations and areas of significant subjectivity

Importance of Documentation



Documentation enables an experienced auditor:

- ☞ With no previous connection to the audit to understand.
- ☞ The nature of the audit **procedures** used.
- ☞ The results and **evidence** obtained.
- ☞ **Significant matters** and conclusions.
- ☞ Significant professional **judgements**.

Contents of Documentation



All documentation should be retained in an audit file.

The audit file will follow the structure below:

- ☞ Planning.
- ☞ Audit work carried out on each section of the financial statements (e.g. Non Current Assets, Inventory).
- ☞ Completion and review.

Auditors must document:

- ☞ What items were tested?
- ☞ Who did the testing?
- ☞ When was the testing?
- ☞ Who reviewed the work and when?

Types of Audit Documentation



- ❧ Planning Documentation (Strategy, plan, risk analysis).
- ❧ Audit programs.
- ❧ Summary of significant matters.
- ❧ Letters of confirmation / representation.
- ❧ Correspondence.



Permanent Audit Files

- ∞ Names of management, those charged with governance, shareholders.
- ∞ Systems Information.
- ∞ Business and Industry background.
- ∞ Title deeds.
- ∞ Contracts.
- ∞ Copy of the company's legal constitution.
- ∞ Board minutes of continuing relevance.
- ∞ Previous years' signed accounts, analytical procedures and management letters.
- ∞ Engagement letters.



Current Audit Files

- œ Financial statements.
- œ Accounts checklists.
- œ Management accounts details.
- œ Reconciliations of management and financial accounts.
- œ A summary of unadjusted misstatements.
- œ Report to partner including details of significant events and misstatements.
- œ Review notes & Notes of board minutes
- œ Audit planning memorandum.
- œ Time budgets and summaries.
- œ Representation letter & Management letter.
- œ Communications with third parties such as experts or other auditors.

Retention of Working Papers



- ☞ Audit files should be updated and finished no later than 60 days after the report.
- ☞ They should then normally be kept for at least 5 years.
- ☞ **So arrangements need to be made for:**
 - a) Secure storage.
 - b) Archiving of the old files.
 - c) IT back ups.

Thank You

By,
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