

Course: Financial Audit

Lecture 7: Pre-planning Activities

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Overview of Lecture 6

ISA 300

- The International Standards on Auditing (ISA) 300 emphasizes that thorough planning is the foundation of an effective audit. Auditors must create a roadmap that outlines the overall strategy and detailed steps for executing the audit.
- The objective of this planning phase is not merely logistical but also strategic. A well-developed plan incorporates the nature, timing, and extent of the audit procedures, ensuring that they are appropriate for the specific risks the entity faces.

Planning

- At its core, the goal of planning is to establish how much and what kind of evidence is necessary to reach a conclusion about the accuracy of the financial statements. This involves:
 - Evidence Collection
 - Risk Assessment
 - Materiality Thresholds

Planning

- Audit planning entails several key steps, each aimed at ensuring the auditor fully understands the entity being audited and the environment in which it operates:
 1. Understanding the Entity and Its Environment
 2. Assessing the Risk of Material Misstatements
 3. Determining Materiality
 4. Creating a Planning Memorandum and Audit Program

Planning

- The audit process is complex, and the proper planning of engagements is essential for several reasons:
 - Ensuring Sufficient Evidence is Gathered
 - Managing Costs
 - Avoiding Miscommunication with Clients

Planning

- The planning phase of an audit involves procedures designed to gain an understanding of the entity's financial and non-financial situation.
- The auditor must review the company's financial performance and position through the lens of both financial data and non-financial.
- This comprehensive understanding helps the auditor anticipate areas of risk and identify where errors might occur.

Planning

- Understanding the entity's internal control mechanisms is crucial. Internal controls help reduce the risk of errors or fraud in financial reporting, so the auditor must evaluate how these controls are designed and whether they are functioning effectively.
- Risk assessment is central to audit planning. Auditors focus on areas with the highest likelihood of material misstatement, such as complex transactions or areas where the company has experienced prior difficulties.

Planning

- Other issues such as the timing of the audit, staffing needs, and potential involvement of other auditors or specialists must also be considered at this stage.
- If issues arise in the early phases, they may require follow-up and adjustments to the audit plan. Ultimately, the auditor decides on the nature, timing, and extent of the audit procedures. This is formalized in the audit program.

Risk Assessment

- Risk assessment drives the entire audit process. Once risks have been identified, the auditor designs the audit to directly address these risks, ensuring that the procedures performed are appropriate to mitigate the likelihood of material misstatements.
- In recognition of the critical importance of risk in auditing, the International Federation of Accountants (IFAC) and the US Auditing Standards Board (ASB) worked together on a project to revise the standards on audit risk. This collaboration led to the publication of three significant ISAs:
 - ISA 315
 - ISA 330
 - ISA 500

Phase 1: Client Acceptance

- Before accepting a client, auditors perform a series of steps to ensure that they can ethically and effectively serve the client. This phase is critical because accepting a high-risk client without thorough investigation could expose the firm to future problems. The steps include:
 - Background Checks: Evaluating the client's background, financial condition, and reasons for requesting an audit.
 - Ethical Considerations: Ensuring the auditor can meet ethical obligations, such as independence and objectivity.
 - Engagement Proposal: Preparing a formal proposal and obtaining an engagement letter that clearly defines the scope and expectations of the audit.

Phase 2: Planning the Audit

- This phase solidifies the auditor's understanding of the client and determines the amount and type of evidence needed. Auditors use this phase to plan audit tests that focus on areas of highest risk and to ensure that the audit is conducted efficiently.

Phase 3: Testing

- During this phase, auditors perform tests on internal controls and financial transactions to gather evidence. This includes:
 - Control Testing: Verifying that the entity's internal controls are functioning as intended.
 - Substantive Testing: Examining financial transactions and balances to ensure their accuracy.
 - Analytical Procedures: Using financial ratios and trends to identify unusual transactions or patterns.

Phase 4: Evaluation

- In the final phase, auditors complete their analysis and issue their report. This includes reviewing the audit evidence, evaluating the governance structure, identifying any subsequent events that might affect the financial statements, and drafting the final audit opinion.

New Standards

- Recent updates to the standards expand the auditor's responsibility in understanding business risks. Auditors must now evaluate significant risks that could affect the financial statements, such as changes in the business environment, technological disruptions, or economic downturns.
- In addition to understanding the design of internal controls, the auditor must assess whether these controls are properly implemented and capable of addressing the identified risks.

Client Acceptance

- Before accepting a client, CPA firms often perform a detailed review of the prospective client's reputation, financial condition, and relationships with other auditors. For instance, firms may be cautious about accepting clients in high-risk industries, such as technology startups or financial services, where the likelihood of failure and legal exposure is higher.

Communication

- When taking over an audit from a previous auditor, the successor auditor must communicate with the predecessor.
- This exchange helps the new auditor determine whether any disputes or issues with the client exist, such as disagreements over accounting principles or audit procedures.
- However, this communication can only take place with the client's consent, as required by confidentiality rules.

Investigations

- In situations where communication with the predecessor auditor is limited or insufficient, auditors may gather information from alternative sources, such as legal advisors, industry experts, or professional investigators. This due diligence is especially important if the client operates in a high-risk environment or has no previous auditor.

Financial Reporting

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Annual Re-Evaluation

- Many CPA firms perform annual evaluations of existing clients to assess whether the client remains suitable for continued auditing services.
- Disputes over the scope of the audit, unpaid fees, or integrity concerns may lead the firm to discontinue the relationship, even with long-standing clients. In some cases, firms may drop clients if the perceived risk of legal or financial issues becomes too great.

ISA 315

- ISA 315 outlines the fundamental procedures auditors must adhere to in order to gather a comprehensive understanding of an entity. This understanding enables auditors to assess risks, particularly the risk of material misstatement, and incorporate these risks into the audit plan.

1. Inquiries of Management

- Auditors begin by engaging in detailed discussions with the client's management and possibly other personnel within the organization. Key areas of inquiry include both short-term and long-term objectives, which could range from maximizing profitability, minimizing operational costs, optimizing working capital, introducing new product lines, or implementing tax reduction strategies.
- Moreover, it is essential to explore management's expectations regarding external stakeholders such as customers, suppliers, shareholders, regulatory bodies, and financial institutions. Additional inquiries might involve lower-level employees or third-party consultants, who could offer valuable insights on operational realities that management may overlook.

2. Analytical Procedures

- Analytical procedures are essential tools auditors use to identify unusual transactions, trends, or discrepancies. These procedures involve comparing the company's financial results against industry standards, previous periods, or projected outcomes.
- Industry benchmarks, widely available in trade publications or statistical databases, serve as valuable reference points. For example, auditors may compare the company's revenue growth, profit margins, or debt ratios against industry norms.

3. Observation & Inspection

- Analytical procedures are essential tools auditors use to identify unusual transactions, trends, or discrepancies. These procedures involve comparing the company's financial results against industry standards, previous periods, or projected outcomes.
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4. Obtaining Information

- Beyond the entity's internal information, auditors may also turn to external sources for valuable insights. Auditors can also rely on professional organizations such as the American Institute of Certified Public Accountants (AICPA), which provide industry-specific audit guides, research materials, and updates on regulatory changes.
- Larger audit firms typically have specialized industry groups that monitor key developments within specific sectors. These groups regularly publish newsletters and bulletins that can help auditors stay informed about new risks, challenges, or emerging trends within the industry that may impact the audit process.

5. Team-Wide Discussions

- ISA 315 mandates a collaborative discussion among the audit team members regarding the likelihood of fraud or errors in the financial statements. This team-based conversation leverages the collective insights of auditors who may have different levels of exposure to various parts of the organization.
- This broader discussion fosters a more balanced view of the organization, allowing the team to consider multiple perspectives beyond the information provided by management. Additionally, team discussions help in brainstorming potential red flags and designing specific audit tests to address the identified risks.

6. Review

- When auditing a continuing client, auditors often begin by reviewing the working papers from previous years. These working papers contain essential information, such as observations made in prior audits, historical accounting policies, and critical financial data.
- However, auditors must exercise caution before relying solely on past information. They should verify whether any substantial changes have occurred in the client's business environment or operations that could invalidate previous assumptions or require a fresh risk assessment.

ISA 315

- ISA 315 identifies several crucial aspects that auditors must consider when gaining an understanding of the client and its environment. These aspects include:
 1. Industry, Regulatory, and External Factors
 2. Nature of the Entity
 3. Objectives, Strategies, and Business Risks
 4. Measurement of Financial Performance
 5. Internal Control

Analytical Procedures

- Analytical procedures play a pivotal role in both the planning and review stages of an audit. These procedures allow auditors to develop expectations based on the relationships between financial data and external benchmarks.
- For example, if an auditor notices that the company's inventory turnover ratio is significantly lower than the industry average, this could indicate issues with inventory management or potential obsolescence.
- Auditors are required to perform these analytical procedures as part of their risk assessment to better understand the client's business and identify areas of heightened risk.

Assessing Misstatement Risks

- Auditors must follow a systematic approach when assessing risks that could lead to material misstatements in financial statements.
- This risk assessment process is central to designing an effective audit strategy and ensuring the accuracy of financial reporting.
- The auditor's task is to evaluate the entity's environment and operations comprehensively, ensuring that potential risks are identified and mitigated.

Assessing Misstatement Risks

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- The auditor's task is to evaluate the entity's environment and operations comprehensively, ensuring that potential risks are identified and mitigated. This involves the following detailed tasks:
 1. Identifying Risks through Understanding the Entity and Its Environment
 2. Relating Identified Risks to Management's Assertions
 3. Determining the Materiality of Risks
 4. Evaluating the Likelihood and Impact of Risks

Business Risks vs Audit Risks

- Business risks arise from internal and external factors that might impede the organization's ability to achieve its strategic goals. These risks could be related to market conditions, operational inefficiencies, regulatory changes, or resource shortages.
- However, unless this shortage affects financial reporting, it does not directly pose an audit risk. Audit risk specifically refers to the risk that financial statements are misstated, and thus auditors might issue an incorrect opinion.

Understanding of Audit Risk

- Audit risk refers to the probability that an auditor may unknowingly issue an incorrect audit opinion on financial statements that contain material misstatements. The essence of audit risk lies in the “reliability” of financial information.
- The higher the audit risk, the more extensive the auditor's work needs to be, requiring more evidence and more rigorous procedures to obtain sufficient assurance before forming an opinion

Breaking Down Audit Risk

- Audit risk consists of three interrelated components, each contributing to the overall risk assessment process. Understanding these components helps auditors tailor their audit strategy:
 - Inherent Risk
 - Control Risk
 - Detection Risk

Balancing Risk Components

- To reduce overall audit risk to an acceptable level, auditors must balance the inherent, control, and detection risks appropriately. When inherent and control risks are high, the auditor must compensate by lowering detection risk through more rigorous and extensive audit procedures.
- The relationship between these risks is central to audit strategy. As a general rule, the higher the inherent and control risks, the more audit evidence must be gathered through substantive procedures to maintain audit risk at an acceptable level.

Significant Risks

- Significant risks are those audit risks that demand special consideration due to their nature, complexity, or potential impact on the financial statements. These risks often arise in areas that involve substantial judgment, complex transactions, or areas where management discretion plays a critical role.

Non-Routine Transactions

- Non-routine transactions are transactions that occur infrequently or are unusually complex. These might involve management intervention in specifying accounting treatments, manual processing, or significant related-party transactions.
- These transactions pose higher risks because they may not be well controlled by routine systems and often require special attention. Understanding these risks is crucial for auditors to design an appropriate audit approach and ensure that the financial statements fairly represent the financial position of the entity.

Significant Risks

- Once an auditor identifies significant risks, special procedures are required. First, the auditor must evaluate the design and implementation of the entity's internal controls to ensure they are effective in addressing these risks.
- This includes reviewing relevant control procedures and obtaining evidence to confirm they are working as intended. Additionally, auditors must apply substantive procedures that directly respond to the identified risks.

Significant Risks

- The determination of what constitutes a significant risk requires professional judgment and involves evaluating several factors:
 - Whether the risk involves potential fraud, such as intentional misstatements or manipulations.
 - The likelihood of the risk occurring and its potential magnitude.
 - The complexity of the transactions involved.
 - Whether the risk relates to unusual or non-routine transactions.
 - The degree of subjectivity involved in measuring the financial impact, such as in estimates or assumptions about future events.
 - Whether related-party transactions are involved, as these often require additional scrutiny.

Materiality

- Materiality is a key concept in auditing, guiding the auditor in determining what is significant enough to influence the decisions of financial statement users.
- For instance, a minor numerical error in a multi-billion-dollar company's financials might be immaterial, whereas the same error in a small business could be significant.
- Auditors must ensure that financial statements are free from material misstatements. During audit planning, auditors establish a materiality threshold, which determines the maximum amount of misstatement that can be tolerated without affecting the fairness of the financial statements. However, auditors need to be careful not to overlook smaller misstatements that could collectively become material. This is particularly relevant when considering uncorrected misstatements that accumulate over time.

Materiality

- Materiality is established at the planning stage of the audit and revised as necessary as the audit progresses. Setting a materiality threshold involves both quantitative and qualitative considerations:
 - Quantitative Materiality: This is usually based on a percentage of key financial statement figures, such as revenue, profit, or equity.
 - Qualitative Materiality: Certain misstatements might be material even if they fall below the quantitative threshold.

Materiality

- When determining materiality, auditors need to account for the nature of financial statement users and the specific circumstances of the entity.
- For instance, creditors are often more interested in liquidity and solvency-related figures, such as current assets and liabilities, and thus auditors may set lower materiality thresholds for these items.
- Investors, on the other hand, may focus on profitability measures, such as earnings per share, and auditors may prioritize materiality thresholds related to income and equity accounts.

Materiality

- According to ISA 320, auditors must assess how materiality interacts with audit risk. As audit risk increases, materiality thresholds might need to be lowered to ensure that any potential misstatements are detected.
- Auditors must gather sufficient and appropriate evidence to reduce the risk of material misstatement to an acceptably low level while ensuring that the financial statements provide a fair view of the entity's financial position.

Conclusion & Closing

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014