Client Evaluation and Planning the Audit

Planning the audit

• Planning stage should include:
  – Procedures covering acceptance of a new audit
  – Establishing an overall audit strategy
  – Developing an audit plan

Acceptance and continuance of client relationships

• The decision to accept (or continue) an audit engagement depends on the client evaluation and ethical and legal considerations
  – ASA 210 Agreeing the Terms of Audit Engagements
  – ASCQ1 Quality Control for Firms that perform Audits and Reviews of Financial Reports and Other Financial Information and Other Assurance Engagements
Acceptance and continuance of client relationships

Steps in accepting an audit engagement

Client evaluation

- Evaluating the integrity of management
  - Communicating with existing auditors
  - Making enquiries of other third parties
  - Reviewing previous experience with existing clients
- Identifying special circumstances and unusual risks
  - Identifying intended users of the audited financial statements
  - Assessing a prospective client's legal and financial stability
  - Evaluating the client's auditability

Ethical and legal considerations

- Ethical considerations relate to whether the audit firm is able to meet independence criteria, complete the engagement with professional competence and perform the audit with due care.
- Legal considerations relate to ensuring compliance with the requirements of the Professional Code of Conduct & Corporations Act in the evaluation of independence and ensuring no conflicts of interest.
Ethical and legal considerations

- Ethical requirements prescribed under Corporations Act
  - Auditor to give written representation that there are no contraventions of independence requirements
  - Auditor should take reasonable steps to ensure conflicts of interest cease
  - Auditor cannot play a significant role in audit of a listed company for more than 5 consecutive years

Ethical and legal considerations

- Assessing competence to perform an audit
  - Engagement team to have appropriate competence and capabilities to perform the audit in accordance with Australian Auditing Standards, legal and regulatory requirements
- Determining ability to use due care
  - Involves review of work done and judgements exercised by those assisting in the audit

Engagement letter

- As a final step in the acceptance phase, in compliance with auditing standards and good professional practice, it is important to confirm the terms of each engagement in an engagement letter
- ASA 210 Terms of Audit Engagements for details of an engagement letter which includes scope of audit procedures, quality control, fees and other matters
Engagement letter

• Engagement letter to include:
  – Objective and scope of the audit
  – Responsibilities of the auditor
  – Responsibilities of management
  – Identification of the applicable financial reporting framework
  – Reference to expected form and content of reports to be issued

Planning the audit

• ASA 300 Planning an Audit of a Financial Report provides the guidelines for the auditor to follow:
  – Audit planning involves the development of an overall plan for the conduct and scope of the audit
  – Adequate planning helps to ensure that appropriate attention is given to important areas of the audit and that problems are identified properly

Steps in the planning process

• Planning starts with obtaining an understanding of the entity and its environment, to understand events, transactions and practices affecting the entity
• Planning also involves setting materiality levels, assessing audit risk and its components and obtaining an understanding of the internal control structure
Steps in the planning process

Understanding of the entity and its environment

- To plan an audit, the auditor should obtain an understanding of the entity and its environment, to understand events, transactions and practices that may have a significant effect on the financial statements.
- This understanding provides a framework for planning an overall audit approach that responds to the unique characteristics of the entity.

Industry conditions

- Understanding industry conditions includes understanding the market for a client’s products, the capacity of competitors relative to market conditions, and price competition.
- Certain industries may also have transactions that increase the risks of material misstatements.
Regulatory issues

• The regulatory environment can have direct economic consequences or affect the accounting and disclosure requirements
• Specific regulatory requirements for particular industries must be considered
• The auditor should be aware that non-compliance with relevant laws and regulations may materially affect the financial statements

Economic factors

• Factors include the general level of economic activity, interest rates, the availability of financing and the level of inflation
• Economic downturns can create circumstances that require write-offs of receivables or inventory etc.
• These conditions increase the inherent risk of misstatements and require close examination by the auditor

The nature of the entity

Business operations
• The auditor needs to gain knowledge of issues such as products and markets, conduct of operations, transactions with related parties etc.
• Need to match accounting policies with the type of business operations
Investments and financing

- Capital investment activities, including investments in technology and non-consolidated activities such as joint ventures, are of significance from an audit perspective.
- Issues such as debt structure, leasing arrangements, guarantees etc. are also important.

Financial reporting and accounting practices

- Accounting principles, revenue recognition practices, accounting for fair values and knowledge of industry-specific practices are all important.

The entity’s objectives, strategies and related business risks

- An entity’s strategies are the operational approaches by which management intends to achieve its objectives.
- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies.
The entity’s objectives, strategies and related business risks

• Some matters the auditor may consider in the previous evaluations include the following:
  – Developments in the industry
  – New products and services
  – Expansion of the business
    • e.g. a potential business risk might be that the estimated demand associated with an expansion has not been accurately estimated
  – Current and prospective financing requirements
    • e.g. a business risk is loss of financing due to inability to meet debt covenant requirements

Measurement and review of financial performance

• Such measures from an audit perspective would include:
  – Key ratios and operating statistics
  – Key performance indicators
  – Employee performance measures
  – Industry trends
  – Forecasts, budgets and variance analysis
  – Analyst reports and credit rating reports

Performing analytical procedures

• Analytical procedures involve a study and comparison of relationships among data to identify expected or unexpected fluctuations and other unusual items
  – Refer ASA 520 Analytical Procedures
• The common types of analytical procedures involve a comparison of the entity’s financial information with:
  – Comparable information for a previous period or periods
  – Expected results such as budgets and forecasts
  – Industry averages
Consideration of fraud in planning

- The importance of considering fraud in the planning of an audit has increased in recent years
- ASA 240 –
  - The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present

Fraud Triangle

In making this assessment need to consider:

- Opportunity
- Incentives/pressures
- Attitudes/rationalisation

Fraud Triangle

- Consideration needs to be in relation to both:
  - Fraudulent financial reporting, and
  - Misappropriation of assets
Auditing for fraud

- Procedures to identify risk of material misstatement due to fraud
  - Enquiries of management
  - Consider any unusual or unexpected relationships identified
  - Consider other information obtained while planning the audit

Audit documentation

- Purpose and function of working papers:
  - Demonstrate that the audit was performed in accordance with auditing standards
  - Monitor progress of the audit
  - Provide a guide to the planning and performance of subsequent audits
  - Record nature, timing and extent of audit procedures performed

Audit documentation

- Working paper files include:
  - Permanent file
  - Current file
  - Working trial balance
  - Schedules and analyses
  - Audit memoranda and corroborating information
  - Proposed adjusting and reclassifying entries
  - Audit program