Chapter 7--Accepting the Engagement and Planning the Audit

There are four phases of an audit:

1--accepting the audit engagement

2--planning the audit

3--performing audit tests

4--reporting the findings

The audit engagement decision is the result of two sets of decisions: the prospective client's and the proposed audit firm's. We focus on the decision of the auditing firm.

Client acceptance/retention decisions are critical due to three forces reshaping the audit environment:

1--society's expectations about the independent auditor's role in maintaining the integrity of the securities markets are increasing;

2--legal liability expansion underscores the importance of the auditors' assessments of the risk components of an audit; and

3--advances in information technology are changing the nature of the attestation process.

Phase I--Accepting the Engagement

In 1992, the AICPA recommended the use of an engagement risk approach in client acceptance/retention decisions. Engagement risk consists of three components:

1--client business risk-the risk associated with the client's survival and profitability;

2--audit risk-the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated; and

3--auditor business risk-the risk of potential litigation costs from an alleged audit failure and the risk of other costs such as fee realization and reputational effects.

Much of the examination of factors that would affect audit risk are actually occurring in the preengagement process. Client business risk, audit risk, and auditor business risk are included in the written risk assessment policies of the Big 5.

<u>Accepting the Engagement</u>

Boynton Johnson, and Kell outline a six-step process in deciding whether to accept an engagement:

1--evaluating the integrity of managment
--material errors and irregularities (and fraud) are more likely when management is dishonest. How does the auditor get data on management's honesty?

2--identifying special circumstances and unusual risks
--here the auditor focuses on identifying the intended users of financial statements. The auditor's legal liability exposure may vary based on the intended statement users, especially under common law negligence.

--those client firms which face potential significant legal claims and/or financial distress raise the probability of an auditor lawsuit. The auditor should talk to management and creditors, review credit reports, and filings with regulatory agencies.
--the auditor should also look for the absence or poor quality of accounting records, weak internal controls, and restrictions imposed by the client on the auditor.

3--assessing competence to perform the audit

AU section 150.02--first general standard.

--which personnel will be assigned to the audit?

The answer to this question determines the amount and type of supervision necessary. The nature of the auditee and its business will affect staffing decisions.

--consultants and specialists should be used by the auditor when needed.

--can the specialist's work effect the type of audit report issued?

4--evaluate independence

--look at the second general standard of GAAS

--Rule 101 of the Code of Conduct requires and defines independence

5--determine the auditor's ability to use due care

--consider the third general standard of GAAS

--Two factors to consider in assessing the ability to use due care:

1. The timing of the appointment

--the earlier the appointment for the engagement the better for the auditor. It leaves more time for planning.

--auditor business risk may be increased by acceptance of an engagement near or after the close of the client's fiscal year.

2. The scheduling of field work

--interim work done 3 to 4 months before the end of a client's fiscal year greatly assists the auditor in planning audit procedures

--good audit planning necessitates the use of a time budget. Estimated hours for each staff member should be in the time budget. This also allows preparation of an estimated audit fee. The deployment of client personnel can have a noticeable influence on client audit fees.

6--preparing the engagement letter

GAAS does not require engagement letters. Why bother?
An engagement letter is a contract between the auditor and client. The specific terms should be set down on paper:

1--the financial statements to be audited

2--the purpose of the audit

3--the professional standards to be followed by the auditor

4--wording related to the nature and scope of the audit

5--a clear statement that the audit may not detect all irregularities

6--the legal duties of accountants to report illegal client acts should be noted

7–apprising management that it is responsible for the preparation of the financial statements and the maintenance of internal controls

8–the basis on which fees will be computed and any billing arrangements

9–a request for the client to confirm the terms of the engagement by signing and returning a copy of the letter to the auditor

Phase II--Planning the Audit

Consider the first standard of field work (adequate planning and proper supervision).

The amount of audit planning is a direct function of the size and complexity of the client. It is also an inverse function of the auditor's knowledge of and experience with the client.

The following steps are involved in audit planning:

1--obtaining an understanding of the client's business and industry

Figure 7-5 provides an overview of the numerous aspects of a client's business that an auditor must understand to perform effectively in an audit. Key issues to focus on are:

–senior management

–management goals and objectives

–entity resources of all types including financial, asset-based, human, information and intangible

–products and services, markets, customers, and competition

–regulatory forces

–core processes and operating cycle

–investing and financing cycle

The auditor also should not forget the importance of learning about "related parties." Related parties are defined by SFAS #57 as affiliates of the enterprise, trusts for the benefit of employees, principal owners of the enterprise, management, other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies.

In reviewing industry and business data, do not forget to review the articles of incorporation, bylaws, B of D meeting minutes, reports to regulatory agencies, and contracts the firm has signed. The auditor should also learn such things as marketing and distribution practices and methods of inventory valuation that are unique to the industry.

Public companies are required under SFAS #14 to disclose segment information for different lines of business in the financial statements. AU section 435 sets forth guidelines for auditing segment information.

The auditor should tour plant facilities. A tour gives an understanding of physical safeguards over assets. The CPA should also review the company's policies dealing with such things as disposal of a portion of the business, credit policies, loans to and from affiliates and officers, and accounting policies for recording assets and recognizing revenues.

The auditor should talk with members of the audit committee and/or board of directors.
Why?

Also, the existence of related parties is important because transactions with

related parties must be disclosed in the financial statements if they are material. The auditor usually requires more competent evidence for related party transactions. AU section 334 indicates that certain auditing procedures should be used to ascertain the existence of related parties transactions.
What are some of these auditing procedures?

GAAP requires disclosure of the nature of related-party relationships; a description of transactions and amounts due from and to related parties.

Performing Analytical Procedures

AU section 329 defines analytical procedures as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data."

Why are analytical procedures used?

1--to obtain a better understanding of the client and its industry
2--to detect financial difficulty
3--to assist in planning the nature, timing, and extent of other auditing procedures

The following steps should be pursued in the planning phase of the audit:

1--decide which computations and analyses will be made

A) These can include common size statements and internal and industry ratio analyses. The auditor must determine whether the client uses the same accounting methods as the remainder of its industry. Different accounting methods can affect comparability.

B) Comparison of the current year balance in an account with the balance of the preceding year

C) Scanning details that make up journals, ledgers, and lists for unusual items

2--develop expectations

An expectation is an estimate of an account balance based on the auditor's analysis of the trend of the account, related financial ratios, and explicit financial models of factors that affect the account. Proper application of analytical procedures in accordance with SAS 56 requires the development of an expectation. This is true regardless of the audit phase in which analytical procedures are used. The expectation is compared with the recorded amount to assess the potential for misstatement.

Auditors commonly use three broad types of analytical procedures to form an expectation:

1--trend analysis--the comparison of a current account balance or item with a trend in two or more prior periods' balances

2--ratio analysis--the comparison of a ratio calculated for the current year with a related ratio for a prior year, an industry average or budget

3--model-based procedures--the use of client operating data and relevant external data (industry and general economic information) to develop an expectation for the account balance. Two main types of procedures--reasonableness and regression analysis.

Model-based procedures differ from ratio and trend analyses in two key ways:

1--while expectation formation is implicit in trend and ratio analyses, expectation formation is explicit in model-based procedures

2--model-based procedures use operating and external data in addition to financial data to develop expectations

Trend analysis is the weakest because it relies on data for only a single account. Ratio analysis is more likely than trend analysis to identify potential misstatement. In ratio and trend analysis, the presumption is that the balance or ratio should compare with the prior year or with the industry average. This brings out an assumption that underlies the use of analytical procedures--that past data relationships continue in the future. Model-based procedures are likely to be much more effective at signalling misstatement.

The modelling approach is more effective because it links financial data directly to relevant operating data. In effect, model-based procedures are a direct test of the consistency between the operating and financial data--an important test in many types of financial statement assertions such as completeness.

An example is the test or rental revenues for a real estate management firm. The use of an analytical procedure to form an expectation of rental revenues based on capacity, occupancy rates and rental charges should provide reliable evidence about the accuracy and completeness of recorded rental revenues.

Precision is the auditor's measure of the potential effectiveness of an analytical procedure. Effectiveness refers to the procedure's ability to identify accounts with or without misstatement, i.e., to correctly identify whether a given fluctuation in an account balance or ratio results from a misstatement.

Precision of an expectation is affected by several factors:

The auditor's consideration of the degree of precision needed for an expectation depends on whether the analytical procedure is used in planning, as a substantive test, or in the final review. Precision is most important in the substantive testing phase because the procedure is relied on to provide audit assurance.

3--do the computations, analyze the data and pick out significant differences

A) identification of unexpected changes or the absence of expected changes may be a warning about potential misstatements in the financial statements

B) an auditor must decide the threshold required for various accounts or line items to be further investigated. This involves the concept of materiality.