Planning an audit assignment

Introduction

Planning an audit is arguably the most important and often the most difficult part of an audit assignment. Its difficulty lies in the perception that audit planning is tedious and does not have any of the 'excitement' of audit execution. Yet if done properly and with attention to detail, proper planning will invariably lead to a more effective audit.

One of the most common complaints from monitoring inspections has been the poorly focused approach of many audits (some copying the previous year's procedures), arising from a lack of adequate planning and failing to address the particular audit risks in the year under review.

Proper planning is especially important in the current climate with going concern and impairment being top of the agenda. These topics have been covered in recent Accountancy Plus articles so I don't propose to repeat what has already been said. Suffice to say that senior staff and partner input will be even more necessary this year during the 'credit crunch', as those who have previous knowledge of a recession have an advantage over less 'battle-hardened' auditors, when planning an audit.

For example, one basic issue to consider is if there is an excess of net current liabilities over current assets, the company may be insolvent (unable to pay their debts as they fall due) and the directors may be exposed to the charge of reckless trading. Ensure the audit file contains documentation of the assessment of the impact of this excess on the audit work and on the implications for the audit report in the period under review?

Preliminary points

The most important starting point is to check that the company is not audit exempt. Then draft the budget for the audit and ascertain whether there is enough time to collect sufficient and reliable audit evidence, so as to express an audit opinion. If there is a potential limitation on the scope of the audit, (e.g. due to lack of time and/or resources to complete it properly) it is best that this is identified as soon as possible.

For new clients – has the full response from the previous auditors been assessed for any implications it may have for the current year's audit? Ensure that the firm's documentation to comply with anti-money laundering (AML) legislation is complete (i.e. 'know your client information', and that full identification checks have been carried out on the directors).

Next, document whether there are any ethical barriers to acting for a new client or continuing to act for an existing client, e.g. if the previous year's audit fees are still outstanding (Ethical Statement 4 'Fees, remuneration and evaluation policies, litigation, gifts and hospitality'), have arrangements been made to have the fees paid?

If the auditor/client relationship has lasted for ten years or more, in the case of a non-listed entity has audit rotation been considered and the resulting action documented? Credit union auditors may have a shorter rotation period imposed by the Financial

Regulator. Once all the threats to independence and objectivity, and safeguards are documented, it is safe to proceed.

For both new and existing clients are all the ethical requirements of the APB Ethical Standards for Auditors (as at April 2008) satisfied? There is not enough space in this article to cover all the potential ethical problems one might encounter, so readers should have a good awareness of the standards. Here, I make mention of a few more important ethical standards.

Of special importance is the size of fees earned from the client itself. The firm must document its assessment of the potential threat to independence that may arise from the quantum of the total fees for both audit and non-audit services (in the case of a non-listed entity) where they will regularly (taken as meaning three consecutive years) exceed 15% of the firm's annual fees (Ethical Statement (ES) 4 paragraph 24). There is a separate subsidiary threshold of 10% to be considered also (paragraph 31 of ES 4).

In addition, account needs to be taken of any former employees from the client that have since joined the audit firm and former employees/partners of the audit firm that may have since joined the client and the need to apply safeguards to protect the independence and integrity of the audit team (Ethical Statement 2 paragraphs 32 to 47 inclusive).

Schedule and hold a pre-audit meeting with the client and keep minutes of the meeting. If the client carries on a regulated business, prepare/obtain a suitable work programme to cover the additional professional and statutory requirements e.g. for credit unions, auctioneers or insurance brokers.

Decide how the audit team should be composed i.e. what specific skills and experience do they need to complete the assignment?

Check all deadlines, such as the company's Annual Return Date, corporation tax filing deadline and any imposed by bankers or the client. Ensure that there is adequate time to meet these deadlines.

Review last year's file and bring forward information of continuing relevance, including matters for partner's attention, and ensure that a current engagement letter reflecting the scope of the relationship in accordance with ISA (UK and Ireland) 210 'Terms of Audit Engagements', has been issued and returned signed by the client.

Send out the usual bank and solicitor's enquiry letters and carry out a full company search. Attend the stocktake, or obtain the stocktake attendance report, if the stocktake has already been attended. If deemed necessary in the audit plan, carry out and document the results of a debtors' circularisation. Ideally this could be carried out in advance of the audit field work in order to save time later and help ensure a better overall response rate.

Agree with the client the work to be prepared by the client in advance of the audit commencing. If properly planned, the work done by the client can help reduce the overall cost of the audit and allow the auditor focus more on critical areas.

The plan should address the nature, timing and extent of the audit procedures to be conducted, the involvement of, and communications with, external experts (such as valuers), other third parties (like banks and legal advisers) and internal auditors, if any.

Audit Team Meeting

Schedule and hold the Audit Team Meeting, also known as the Brainstorming meeting. A draft audit planning memorandum should be prepared in advance of the meeting by the Audit Manager or most senior member of the audit team and used as a discussion document.

This meeting should be chaired by the Responsible Individual (usually the audit partner). The meeting should discuss how the final audit plan will be structured and how any follow-up issues from the previous period will be dealt with (e.g. weaknesses arising from the prior period's letter to those charged with governance).

The meeting should address the potential for fraud or material misstatement to go unnoticed by management and the auditors, and address what specific audit tests the auditors will implement to either eliminate or reduce the risks identified to an acceptably low level. The draft audit planning memorandum should be finalised after this meeting.

Audit Planning Memorandum

The audit planning memorandum which should contain the following points:

1. Engagement requirements

   List all the reporting requirements e.g. appropriate legislation, audit or any additional report or return to a regulator.

2. Knowledge of the entity

   Update the recorded knowledge of the entity and areas of change since last year. Consider the implications for the audit of your knowledge arising from any significant changes e.g. a slow down in credit collection may warrant an increased sample size for a debtors circularisation.

   The knowledge of the entity documentation should include:
   - details of the entity's business operations
   - names and experience levels of management and staff
   - details of the main products and services with price lists
   - list the top 5 suppliers
   - list the top 5 customers
   - names of the main geographic locations where the company operates
   - any other matters deemed relevant

3. Materiality

The level of materiality used to evaluate the results of tests and especially at the financial statements level is a matter for the auditor's judgement. Where appropriate, separate materiality calculations can be prepared for the profit and loss account and balance sheet under paragraphs 15 to 17 of ISA (UK & Ireland) 200 'Objective And General Principles Governing An Audit Of Financial Statements' and paragraphs 7 to 9 of ISA (UK & Ireland) 320 'Audit Materiality'.

4. Financial information

   Document the main sources of finance, bank guarantees, covenants, the financial reporting objectives and accounting policies of the entity, noting any changes from last year or any breaches of bank covenants/lending criteria. These notes should also address profitability, solvency, going concern, and potential impairment of tangible/intangible assets.

5. Industry and Other External Factors

   Document the firm's knowledge of industry conditions impacting on the client and the general recessionary conditions all companies face right now. Assess the impact of the downturn versus the company's main competitors and consider whether they pose a significant or increasing threat. Document any other external factors currently affecting the entity's business e.g. loss of a key customer.

6. Consideration of Laws & Regulations

   List the laws and regulations that are relevant to the conduct of the client's business, e.g. health and safety, etc. and whether the entity has had any external inspections from regulatory bodies (e.g. fire safety inspection of a hotel). Briefly list the laws and regulations that are relevant to the conduct of the client's business and record your discussions with management as to whether there have been any breaches of the laws or regulations identified above. Assess whether you believe there is a risk of a breach, and what consequences this has for the audit approach.

7. Ownership and governance of the entity

   List the basic details of shareholdings, board of directors and detail the governance and reporting structure of the entity, noting any changes from the previous year and consider the implications for the audit of any changes e.g. should particular evidence be sought from board minutes with a view to checking that particular matters have occurred e.g. approval of major contracts by the company?

8. Accounting systems

   Ascertain whether the current period accounting policies are consistent with the previous period and appropriate for the client's business and industry sector. Record or update the existing record of the accounting systems, how they operate and who operates them in a way that is sufficient for the purposes of gaining a proper understanding of any weaknesses in the systems of control over the accounts production function. Discuss these control findings with the management of the company and note their responses. Consider the implications for the audit of any strengths or weaknesses in control, and of any changes in the systems and controls in the business, e.g. have there been any changes in the way journal entries are authorised or processed in the company? Consider specifically testing journal entries, as it has been found from past experience that frauds have been perpetrated using journal entries to cover up poor performance in times of financial stress.

9. Consider the operating style and the 'tone at the top' of the management of the entity. Entities that are managed by 'dominant' personalities may need a more robust audit approach.

10. Related Parties – obtain a list of all the related parties and the actual or expected transactions or types of transactions with them and assess the impact of these related parties on the audit approach?

11. Preliminary Analytical Review

    Carry out a preliminary analytical review of the business e.g. based on draft accounts and other management information like sales per square foot, sales per employee, profit per store, etc. Discuss performance with management, and pay particular attention to changes in activities since the prior financial period. Consider whether the business has performed as expected, and what changes are revealed by the review.

12. Risk of fraud

    On the basis of the knowledge already gained about the client, list the key risks identified and detail how they will be addressed in the audit, in particular the risk of fraud. Record the discussion with the engagement team about the risk of fraud and subsequently follow up the discussion points with the management of the entity, taking account of any knowledge that you have from other areas which might indicate a risk of fraud. Document the response of management and assess whether there is potential for management override of certain internal controls. Assess the impact on your work programme of the results of the above assessment. Basically the greater the likelihood of fraud or material misstatement occurring, the greater the level of audit work will be necessary.

In conclusion

In concluding the planning of the assignment, make sure to outline what the firm believes might be included in the Significant Matters Memorandum, which is a prelude to the 'Letter to those Charged with Governance of the Entity'.

Obviously the points to be included in the letter will evolve over the course of the audit, but some of its content may arise as a result of matters identified during planning. The ISAs place a great deal of emphasis on the audit team maintaining ‘professional scepticism’, and not allowing one’s questioning mind be dulled by client familiarity.

Under ISA (UK and Ireland) 260 ‘Communication Of Audit Matters With Those Charged With Governance’ paragraph 16-2, such a letter is *‘issued even if its content is limited to explaining that there is nothing the auditor wishes to draw to the attention of those charged with governance. To avoid doubt where there are no matters the auditor wishes to communicate in writing, the auditor communicates that fact in writing to those charged with governance.’*

If the audit planning identifies that an Independent Partner Review is appropriate (e.g. because the client is in a high risk industry, has significant borrowings/assets and/or is likely to receive a qualified audit report this year or had one last year), ensure the relevant independent partner is involved in the planning of the audit. If the firm is a sole practitioner, an appropriate external firm or external training body, suitably licensed as registered auditors, may perform the role.

Finally communicate and agree the plan and the budget for the audit with the board of directors (those charged with governance of the entity or their equivalent) and confirm that the firm’s independence is not compromised by the provision of any non-audit services.

Happy auditing!

This article originally appeared in Accountancy Plus, the Official Journal of the Institute of Certified Public Accountants in Ireland in June 2009.

John McCarthy FCA, Dip. IFRS of John McCarthy Consulting Limited is the former Director of Professional Standards at Grant Thornton, Dublin. Prior to this he spent nine years with Chartered Accountants Ireland as their Senior Practice Consultant working with over 1,000 chartered accountancy practices on regulatory, technical and management issues. He also created and authored their very popular newsletter for practitioners ‘Practice Matters’. He is a member of the Audit and Assurance Committee of Chartered Accountants Ireland.

John is a regular speaker on practice management matters, succession planning, compliance and audit/accounting technical matters and is has extensive experience in the provision of technical and strategic support to practicing accountants throughout Ireland. He has spoken at seminars and conferences for Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, the Chartered Institute of Management Accountants (Members in Practice Committee) and the Institute of Chartered Accountants of Scotland.

John may be contacted at **00 353 86 839 8360** or at **john@jmcc.ie**