AUDIT PLANNING

Highlights of Technical Clinic

BY
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An audit needs to be properly planned before the detailed audit work begins. Adequate audit planning helps to ensure that adequate resources are allocated to important areas of the audit and that potential problems are identified on a timely basis. Mona Low, Managing Partner of Low Yap & Associates, facilitated this topic at a technical clinic for a group of practitioners. The main highlights are presented here.

Q1 WHAT ARE THE PRELIMINARY ENGAGEMENT ACTIVITIES THAT THE AUDITOR NEEDS TO UNDERTAKE AT THE BEGINNING OF AN ENGAGEMENT?

Singapore Standards on Auditing (SSA) 300 para 6 requires the auditor to perform preliminary engagement activities regarding (i) Engagement acceptance and continuance; (ii) Evaluation of compliance with ethical requirements including independence, and (iii) Establishing an understanding of the terms of the engagement.

The auditor needs to make sure these pre-planning procedures have been carried out and properly concluded before kickstarting the audit planning process. Such work has to be performed regardless of whether the engagement is new or recurring. Let us illustrate with two examples.

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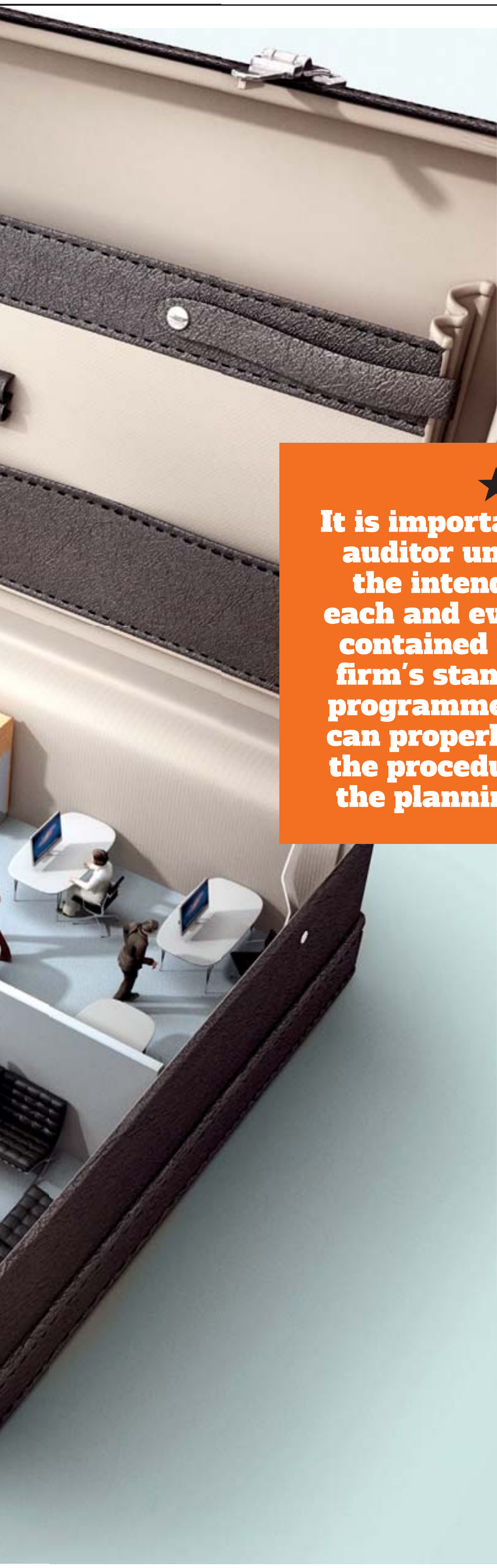

It is important that the auditor understands the intended use of each and every section contained within the firm's standard audit programme so that he can properly carry out the procedures during the planning process.

EXAMPLE 1 NEW ENGAGEMENT

The firm has been approached to undertake an audit of a company that operates in a specialised industry (for example, construction). Prior to accepting the engagement, the firm needs to go through its client acceptance policies and procedures. The auditor needs to assess the integrity of the potential client; consider whether he has the competence and expertise to take on the engagement, and whether the firm is in compliance with relevant ethical requirements.

There are a number of checklists issued by various professional bodies to aid the auditors in such an assessment. One of them is Template A1 of the Singapore Standard on Quality Control (SSQC) 1 Guide 2 issued by the Institute of Singapore Chartered Accountants (ISCA). Thereafter, if the auditor decides to accept the engagement, the auditor needs to clearly communicate the terms of the engagement to the management or those charged with governance of the company to be audited.

EXAMPLE 2 RECURRING ENGAGEMENT

The firm has been the auditor for the company for many years. Even so, prior to the commencement of the planning process, the auditor is required to perform work to assess whether the firm can continue as the auditor for the company. Specifically, the firm should obtain an update on the significant changes in the client's businesses and operations and re-evaluate the risk of the engagement. Circumstances that may increase the risk of the engagement and therefore affect the firm's decision to continue with the engagement include (the list is not exhaustive):

- Merger of the client with another entity of similar size;
- Issue with management integrity;
- Issue on fee collection;
- Change in key management personnel, and
- Significant investment in other industries or same industry but in other jurisdictions.

If the auditor, after performing the continuance procedures, decides to continue with the audit of the company, he should then consider whether there is a need for the firm to re-issue the engagement letter. The auditor can refer to SSA 210 para A28 for more guidance on the factors to be considered in re-issuing an engagement letter.

Q2 WHAT ARE THE COMMON PROCEDURES THAT THE AUDITOR CAN PERFORM AS PART OF THE PLANNING PROCESS, PARTICULARLY FOR SMALL AND MEDIUM-SIZED PRACTICES, TO OBTAIN AN UNDERSTANDING OF THE COMPANY TO BE AUDITED?

The common procedures that the auditor can perform are as follows (the list is not exhaustive):

i) Request for management accounts from the company's director or finance personnel to perform a preliminary analytical review against prior year's audited figures as well as the expectation formed at the planning stage to identify any unusual or significant variance and seek clarification from the management.

ii) Schedule a preliminary discussion with management involving the engagement partner and other key members of the engagement team.

Examples of matters that can be discussed are:

- Clarification with management on the unusual/significant variance identified during the preliminary analytical review;
- Inquiry of significant developments/future plans for the company (for example, changes in key management, plan to dispose of a significant business operation or expand into overseas markets);
- Inquiry of significant or potential issues faced by management (for example, obsolete stocks, collectability of trade receivables);
- Inquiry of management's assessment of the potential risk that the financial statements may be materially misstated due to fraud that occurred during the year (for example, misappropriation of petty cash or unauthorised payment by finance personnel).

The above discussion can be performed through a formal meeting or a conference call with the management.

iii) Perform a walkthrough of the key business processes of the company such as the revenue/receipt cycle, purchase/procurement payment cycle, inventory control cycle and payroll cycle to evaluate the design effectiveness of the internal control of that company.

Such a walkthrough would include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Through the walkthrough, the auditor determines whether the design of the controls is effective and whether the controls are carried out by persons with the necessary authority and competence to prevent or detect errors or fraud that could result in material misstatements in the financial statements.

For a recurring audit, the focus would be different as most of the information would have been obtained through previous experience of auditing that company. In such an audit, the auditor needs to obtain an update on any significant changes to the company's operations and internal controls, as well as changes to the external environment. Where significant changes are identified, the auditor would need to consider the implication to the audit for the current year and incorporate necessary changes to the audit approach in the audit plan.

Q3 HOW CAN THE AUDITOR PREPARE A MORE EFFICIENT AND EFFECTIVE AUDIT PLAN?

In most small and medium-sized practices (SMPs), the auditors may adopt a standard audit programme such as those in the Audit Manual issued by ISCA or other third-party practice aids. Auditors need to be wary of adopting these audit programmes or practice aids without proper

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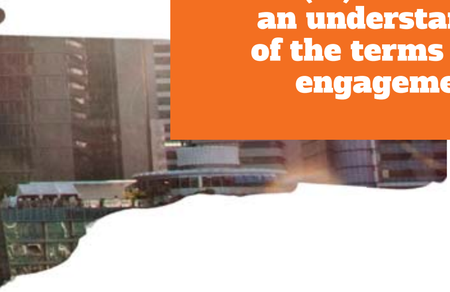

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> **SSA 300 para 6 requires the auditor to perform preliminary engagement activities regarding (i) Engagement acceptance and continuance; (ii) Evaluation of compliance with ethical requirements including independence, and (iii) Establishing an understanding of the terms of the engagement.**

customisation, to avoid being too checklists-oriented. This is because typically, the task of planning the audit is delegated to junior audit staff who may not understand the rationale of preparing an audit plan or the objectives of the procedures stated in the audit programme. In addition, the lack of the audit partner's involvement and inputs at the planning stage may result in inefficient audits and/or higher audit risks.

It is important that the auditor understands the intended use of each and every section contained within the firm's standard audit programme so that he can properly carry out the procedures during the planning process. In addition, the Audit Manual serves only as a guide to the auditor – it is not a one-size-fits-all audit approach to all types of audit. The nature and size of each client's operation, the complexity of each engagement and other information obtained during the planning process play a part in deciding the extent of the risk assessment and planning process to be performed.

Take the example of an audit of a property investment company that only holds a single property which is sublet to a third party. Instead of completing the entire audit planning section contained in the Audit Manual, the auditor may choose to document the audit plan, including planning procedures and the results, in a single planning memorandum. In this case, the auditor needs to ensure that the documentation addresses all the planning requirements and includes the necessary details such as the auditor's basis for acceptance as well as his risk assessment.

Q4 WHAT IS THE DIFFERENCE BETWEEN RISKS AT FINANCIAL STATEMENT LEVEL AND RISKS AT ASSERTION LEVEL?

SSA 315 para A105 states that "risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions." Examples of such risks include but are not limited to the following:

- ***Management override of controls*** Presence of domineering board of directors and senior management which oversee the daily operations of the company;
- ***Going concern*** Indications that the company may not be able to continue as a going concern in the next 12 months, such as net liabilities position;
- ***Competency of finance personnel*** Finance personnel lacks appropriate accounting and financial reporting skills.

Such risks generally affect most financial statement balances and will require an overall response, such as assigning more experienced staff, increasing supervision of work performed by junior staff and incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures. Further guidance is set out in SSA 240 para 29.

On the other hand, assertion level risks are risks that are limited to one or more specific assertions in an account or in several accounts, for example, the occurrence of sales. Assertion level risks are addressed by including additional procedures or varying the nature, timing, and extent of standard audit procedures (refer to Table 1 on the next page for illustration).

Q5 MUST REVENUE RECOGNITION BE INCLUDED AS A SIGNIFICANT RISK IN ALL ENGAGEMENTS?

SSA 240 (R) para 26 states, "When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks." If the auditor concludes that the presumed risk of fraud on revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reason(s) for such conclusion.

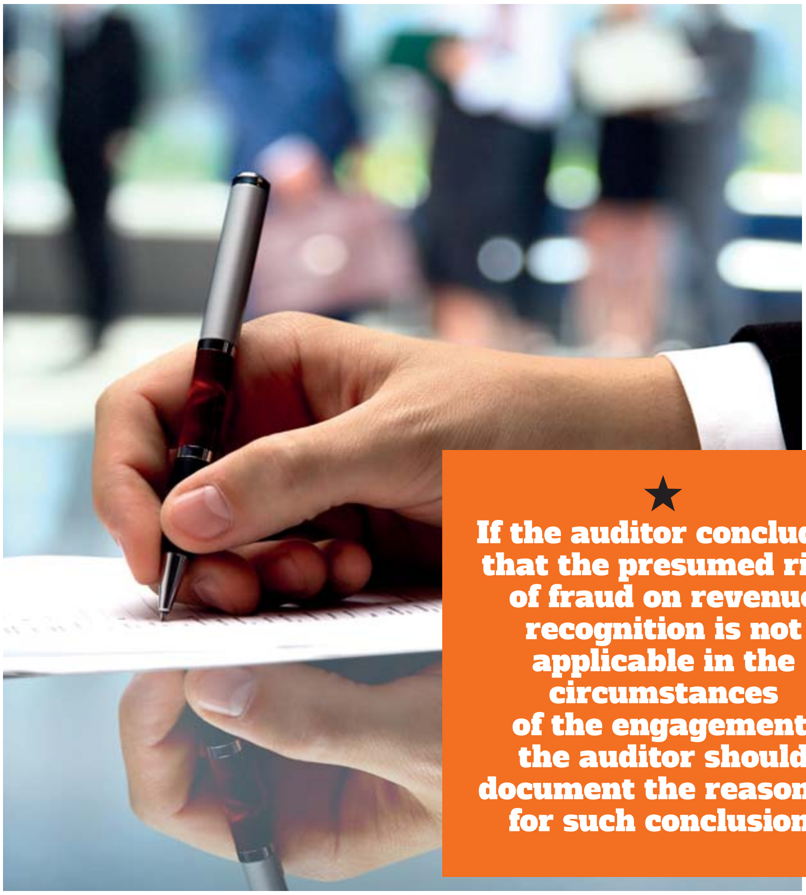
We take an example of a company that generates rental income by

TABLE 1 Assertion risk action plan extracted from C8.3 of the Audit Manual (for illustration only)

SPECIFIC RISK AFFECTING CLIENT	H, M, L	MANAGEMENT RESPONSE	FINANCIAL REPORTING AREAS & ASSERTIONS AFFECTED	AUDIT APPROACH	OUTCOME (FINAL AUDIT)
Revenue recognition – presumed risk of fraud (key management's remuneration is linked to the sales of the company)	H	Management commented that the company has controls in place to check the validity of the sales. WORK PERFORMED Refer to evaluation performed in C5.1*; noted that there is no proper segregation of duties and hence substantive testing approach is adopted.	Sales – Occurrence	> Select 20**additional samples (based on auditor's judgement) for sales that occurred in the last quarter of the financial year. > Review the (i) journal entries passed and (ii) credit notes issued two months** after the financial year for any reversal of revenue.	Cross-referenced to work performed in the respective audit sections.

*C5.1 - Review of design & implementation of internal controls is not illustrated in this example.

**For our illustration purpose, the sample size and period of review are determined based on the auditor's judgement specific to the circumstance set out in the question.



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leasing its property to a third party. The rental arrangement between the company and the third party is supported by an agreement which includes terms and conditions that are mutually agreed by both parties and the total rental income for the year can be easily rationalised (assuming fixed monthly rental charge). The auditor has evaluated the risk relating to the rental income taking into consideration the fraud risk factors listed under Appendix 1 to SSA 240 and has concluded that the risk of material misstatement of rental income due to fraud is low. Under such circumstances, the auditor needs to document the nature of the revenue, the evaluation of the risks including the fraud risk factors considered and the conclusion that the risk relating to revenue (that is, rental income) is low. ISCA

If the auditor concludes that the presumed risk of fraud on revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reason(s) for such conclusion.

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