**THE AUDIT PROCESS**

YES

NO

NO

1. Accept client and do initial planning

**Initial audit planning** involves four things, all of which should be done early in the audit:

1. The auditor decides whether to accept a new client or continue serving an existing one. This determination is typically made by an experienced auditor who is in a position to make important decisions. The auditor wants to make this decision early, before incurring any significant costs that cannot be recovered.

2. The auditor identifies why the client wants or needs an audit. This information is likely to affect the remaining parts of the planning process.

3. To avoid misunderstandings, the auditor obtains an understanding with the client about the terms of the engagement.

4. The auditor develops an overall strategy for the audit, including engagement staffing and any required audit specialists.

Even though obtaining and retaining clients is not easy in a competitive profession such as public accounting, a CPA firm must use care in deciding which clients are accept able. The firm’s legal and professional responsibilities are such that clients who lack integrity or argue constantly about the proper conduct of the audit and fees can cause more problems than they are worth. Some CPA firms now refuse any clients in certain high-risk industries, such as software technology companies, health, and casualty insurance companies, and may even discontinue auditing existing companies in those industries. Some smaller CPA firms will not do audits of publicly held clients because of , the risk of litigation or because of costs associated with registering the audit firm with the PCAOB. Stated in terms of acceptable audit risk, an auditor is unlikely to accept a new client or continue serving an existing client if acceptable audit risk is below the risk threshold the firm is willing to accept.

For new clients, it is important to investigate the prospective client standing in the business community, financial stability and relations with the previous auditor. Specifically, the auditor should;

* Communicate with the previous auditor. Permission for this communication should be sought from the client in case of unusual circumstances such as legal problems or disputes between the client and the auditor. If the client declines to grant permission for such communication, the auditor should consider the desirability of accepting the appointment without conducting other investigation. Such other investigations may be conducted by gathering information from the lawyers of the company, other CPAs, banks and other businesses.

For continuing clients, CPA firms evaluate existing clients annually to determine whether there are reasons for not continuing to do the audit. Previous conflicts over the appropriate scope of the audit, the type of opinion to issue, unpaid fees, or other matters may cause the auditor to discontinue association. The auditor may also drop a client after determining the client lacks integrity. Even if none of the previously discussed conditions exist, the CPA firm may decide not to continue doing audits for a client because of excessive risk. For example, a CPA firm might decide that considerable risk of a regulatory conflict exists between a governmental agency and a client, which could result in financial failure of the client and ultimately lawsuits against the CPA firm. Even if the engagement is profitable, the long-term risk may exceed the short-term benefits of doing the audit.

A clear understanding of the terms of the engagement should exist between the client and the CPA firm. Auditing standards require that auditors document their under - standing with the client in an **engagement letter**, including the engagement’s objectives, the responsibilities of the auditor and management, and the engagement’s limitations. For public companies, the audit committee is responsible for hiring the auditor. The engagement letter is typically signed by management for private companies. The engagement letter may also include an agreement to provide other services such as tax returns or management consulting allowed under the Code of Professional Conduct and regulatory requirements. It should also state any restrictions to be imposed on the auditor’s work, deadlines for completing the audit, assistance to be provided by the client’s personnel in obtaining records and documents, and schedules to be prepared for the auditor. It often includes an agreement on fees. The engagement letter also serves the purpose of informing the client that the auditor cannot guarantee that all acts of fraud will be discovered. Engagement letter information is important in planning the audit principally because it affects the timing of the tests and the total amount of time the audit and other services will take. For example, if the deadline for submitting the audit report is soon after the balance sheet date, a significant portion of the audit must be done before the end of the year. If unexpected circumstances arise or if client assistance is not available, arrangements must be made to extend the amount of time for the engagement. Client-imposed restrictions on the audit can affect the procedures performed and possibly even the type of audit opinion issued.

1. Understand the client’s business and industry

A thorough understanding of the client’s business and industry and knowledge about the company’s operations are essential for the auditor to conduct an adequate audit. The second standard of field work states: The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

The nature of the client’s business and industry affects client business risk and the risk of material misstatements in the financial statements. (Client business risk is the risk that the client will fail to meet its objectives.) In recent years, several factors have increased the importance of understanding the client’s business and industry:

* Recent significant declines in economic conditions around the world are likely to significantly increase a client’s business risks. Auditors need to understand the nature of the client’s business to understand the impact of major economic downturns on the client’s financial statements and ability to continue as a going concern.
* Information technology connects client companies with major customers and suppliers. As a result, auditors need greater knowledge about major customers and suppliers and related risks.
* Clients have expanded operations globally, often through joint ventures or strategic alliances.
* Information technology affects internal client processes, improving the quality and timeliness of accounting information.
* The increased importance of human capital and other intangible assets has increased accounting complexity and the importance of management judgments and estimates.
* Many clients may have invested in complex financial instruments, such as collateralized debt obligations or unusual mortgage backed securities, which may have declined in value, require complex accounting treatments, and often involve unknown counterparties who may create unexpected financial risks for the client.

External and Industry environment

The three primary reasons for obtaining a good understanding of the client’s industry and external environment are:

* Risks associated with specific industries may affect the auditor’s assessment of client business risk and acceptable audit risk—and may even influence auditors against accepting engagements in riskier industries, such as the financial services and health insurance industries.
* Many inherent risks are common to all clients in certain industries. Familiarity with those risks aids the auditor in assessing their relevance to the client. Examples include potential inventory obsolescence in the fashion clothing industry, accounts receivable collection inherent risk in the consumer loan industry, and reserve for loss inherent risk in the casualty insurance industry.
* Many industries have unique accounting requirements that the auditor must understand to evaluate whether the client’s financial statements are in accordance with accounting standards. For example, if the auditor is doing an audit of a city government, the auditor must understand governmental accounting and auditing requirements. Unique accounting requirements exist for construction companies, railroads, not-for-profit organizations, financial institutions, and many other organizations.

Below is a summary of the issues that an auditor should seek to understand, and the ways through which such understanding may be sought.

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| --- | --- |
| What to Understand | How to gain understanding |
| **Business operation and processes**  The auditor should understand factors such as major sources of revenue, key customers and suppliers, sources of financing, and information about related parties that may indicate areas of increased client business risk. For example, many technology firms are dependent on one or a few products that may become obsolete due to new technologies or stronger competitors. Dependence on a few major customers may result in material losses from bad debts or obsolete inventory. | * Tour client facilities and operations.   Observe operations first hand and meet key personnel. By viewing physical facilities, auditor can assess physical safeguards over assets and interpret such accounting data as inventory in process and factory equipment.   * Identify related parties.   Related party is defined in auditing standards as an affiliated company, a principal owner of the client company, or any other party with which the client deals, where one of the parties can influence the management or operating policies of the other e.g. transactions between parent and subsidiary company, loans made to company officers e.t.c. Transactions with related parties are important to auditors because accounting standards require that they be disclosed in the financial statements if they are material. |
| **Management and governance**  Because management establishes a company’s strategies and business processes, an auditor should assess management’s philosophy and operating style and its ability to identify and respond to risk, as these significantly influence the risk of material misstatements in the financial statements. | * Code of Ethics   Companies frequently communicate the entity’s values and ethical standards through policy statements and codes of conduct. Auditors should gain knowledge of the company’s code of ethics and examine any changes and waivers of the code of conduct that have implications about the governance system and related integrity and ethical values of senior management.   * Minutes of Meetings   They include key authorizations and summaries of the most important topics discussed at these meetings and the decisions made by the directors and stockholders. The auditor should read the minutes to obtain authorizations and other information that is relevant to performing the audit. This information should be included in the audit files by making an abstract of the minutes or by obtaining a copy and underlining significant portions. |
| **Objectives and strategies**  Strategies are approaches followed by the entity to achieve organizational objectives. Auditors should understand client objectives related to:   * Reliability of financial reporting * Effectiveness and efficiency of operations * Compliance with laws and regulations | * Despite management’s best efforts, business risks arise that threaten management’s ability to achieve its objectives. As a result, knowledge of client objectives and strategies helps the auditor to assess client business risk and inherent risk in the financial statements. For example, product quality can have a significant impact on the financial statements through lost sales and through warranty and product liability claims. |
| **Measurement and performance**  A client’s performance measurement system includes key performance indicators that management uses to measure progress toward its objectives. These indicators go beyond financial statement figures, such as sales and net income, to include measures tailored to the client and its objectives. Such key performance indicators may include market share, sales per employee, unit sales growth, unique visitors to a Web site, same-store sales, sales by country, and sales per square foot for a retailer. | Inherent risk of financial statement misstatements may be increased if the client has set unreasonable objectives or if the performance measurement system encourages aggressive accounting. For example, a company’s objective may be to obtain the leading market share of industry sales. If management and salespeople are compensated based on achieving this goal, there is increased incentive to record sales before they have been earned or record sales for nonexistent transactions. In such a situation, the auditor is likely to increase assessed inherent risk and the extent of testing for the occurrence transaction-related audit objective for sales.  Performance measurement includes ratio analysis and benchmarking against key competitors. As part of understanding the client’s business, the auditor should perform ratio analysis or review the client’s calculations of key performance ratios. Performing preliminary analytical procedures is the fourth step in the planning process and is discussed later. |

1. Assess client business risk.

The auditor uses knowledge gained from the understanding of the client’s business and industry to assess **client business risk**, the risk that the client will fail to achieve its objectives. Client business risk can arise from any of the factors affecting the client and its environment, such as significant declines in the economy that threaten the client’s cash flows, new technology eroding a client’s competitive advantage, or a client failing to execute its strategies as well as its competitors. The auditor’s primary concern is the risk of material misstatements in the financial statements due to client business risk. For example, companies often make strategic acquisitions or mergers that depend on successfully combining the operations of two or more companies. If the planned synergies do not develop, the fixed assets and goodwill recorded in the acquisition may be impaired, affecting the fair presentation in the financial statements. Management is a primary source for identifying client business risks. In public companies, management should conduct thorough evaluations of relevant client business risks that affect financial reporting to be able to certify quarterly and annual financial statements, and to evaluate the effectiveness of disclosure controls and procedures.

1. Perform preliminary analytical procedures

Refer to topic on audit evidence. Why conduct analytical procedures? One of the reasons Auditors performs preliminary analytical procedures to better understand the client’s business and to assess client business risk. One such procedure compares client ratios to industry or competitor benchmarks to provide an indication of the company’s performance. Such preliminary tests can reveal unusual changes in ratios compared to prior years, or to industry averages, and help the auditor identify areas with increased risk of misstatements that require further attention during the audit. Please note that

* Analytical procedures are *required* in the *planning phase* to assist in determining the nature, extent, and timing of audit procedures. This helps the auditor identify significant matters requiring special consideration later in the engagement. For example, the calculation of inventory turnover before inventory price tests are done may indicate the need for special care during those tests.
* Analytical procedures are often done during the *testing phase* of the audit as a substantive test in support of account balances. These tests are often done in conjunction with other audit procedures. For example, the prepaid portion of each insurance policy might be compared with the same policy for the previous year as a part of doing tests of prepaid insurance. The assurance provided by analytical procedures depends on the predictability of the relationship.
* Analytical procedures are also *required during the completion phase* of the audit. Such tests serve as a final review for material misstatements or financial problems and help the auditor take a final “objective look” at the audited financial statements. Typically, a senior partner with extensive knowledge of the client’s business conducts the analytical procedures during the final review of the audit files and financial statements to identify possible oversights in an audit.

1. Set materiality and assess acceptable audit risk and inherent risk (refer to topic on audit risk and materiality).
2. Understand internal controls and assess control risk

Internal controls have several objectives, the most important being;

* Ensuring reliability of financial reporting.
* Ensure efficiency and effectiveness of operations.
* Ensure compliance with laws and regulations.

The management designs the system of internal controls to accomplish these objectives.

Because of its importance, knowledge about a client’s internal control is included in a separate generally accepted auditing standard. The second GAAS field work standard states “The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures.” The auditor obtains the understanding of internal control to assess control risk in every audit. Auditors are primarily concerned about controls over the reliability of financial reporting and controls over classes of transactions.

COSO Components of internal controls

The COSO internal control components include the following:

* Control environment

These are actions, policies and procedures that reflect the overall attitude of top management, directors and owners of the entity about internal controls and its importance. Examples; integrity and ethical values, commitment to competence, BoD and audit committee participation, e.t.c.

* Risk assessment

Management identification and analysis of risks relevant to the preparation of financial statements in accordance with appropriate accounting framework like IFRS/ IAS. It includes risk assessment processes such as identifying factors affecting risk, assessing significance of risk and likelihood of occurrence, and determining actions necessary to manage risk. It also includes Categories of management assertions that must be satisfied: Assertions about classes of transactions and other events, assertions about account balances and assertions about presentation and disclosure

* Control activities

These are policies and procedures that management has established to meet its objectives for financial reporting. They include adequate segregation of duties, Proper authorization of transactions and activities, adequate documents and records, Physical control over assets and records, and Independent checks on performance.

* Information and communication

Methods used to initiate, record, process and report an entity’s transactions and to maintain accountability for related assets. In this regard, there are some transaction related audit objectives that must be met; occurrence, completeness, accuracy, posting and summarization, classification and timing.

* Monitoring

Refers to the management’s ongoing and periodic assessment of the quality of internal control performance to determine whether controls are operating as intended and are modified when needed.

Understanding and documenting internal controls

As part of the auditor’s risk assessment procedures, the auditor uses procedures to obtain an understanding, which involve gathering evidence about the design of internal controls and whether they have been implemented, and then uses that information as a basis for the integrated audit. We have looked into the various ways of assessing and testing controls in the revenue process. This evidence on internal controls must also be documented. Documenting internal controls is done through either or a combination of;

A narrative (narrative notes)

Narrative of an accounting system/ related controls describes four things:

* *The origin of every document and record in the system.* For example, the description should state where customer orders come from and how sales invoices are generated.
* *All processing that takes place.* For example, if sales amounts are determined by a computer program that multiplies quantities shipped by standard prices contained in price master files, that process should be described.
* *The disposition of every document and record in the system.*

*The filing of documents, sending them to customers, or destroying them should be described.*

* *An indication of the controls relevant to the assessment of control risk.*

*These typically include separation of duties (such as separating recording cash from handling cash), authorizations and approvals (such as credit approvals), and internal verification (such as comparison of unit selling prices to sales contracts).*

**Flowchart**

An internal control **flowchart** is a diagram of the client’s documents and their sequential flow in the organization. An adequate flowchart includes the same four characteristics identified for narratives. Well prepared flowcharts are advantageous primarily because they provide a concise overview of the client’s system, which helps auditors identify controls and deficiencies in the client’s system. Flowcharts have two advantages over narratives: typically they are easier to read and easier to update. It is unusual to use both a narrative and a flowchart to describe the same system because both present the same information.

**Internal Control Questionnaire**

An **internal control questionnaire** asks a series of questions about the controls in each audit area as a means of identifying internal control deficiencies. Most questionnaires require a “yes” or a “no” response, with “no” responses indicating potential internal control deficiencies. By using a questionnaire, auditors cover each audit area reasonably quickly. The two main disadvantages of questionnaires are their inability to provide an overview of the system and their inapplicability for some audits, especially smaller ones.

The use of questionnaires and flowcharts together is useful for understanding the client’s internal control design and identifying internal controls and deficiencies. Flow - charts provide an overview of the system, while questionnaires offer useful checklists to remind the auditor of many different types of internal controls that should exist. In addition to understanding the design of the internal controls, the auditor must also evaluate whether the designed controls are implemented (test of controls). In practice, the understanding of the design and implementation are often done simultaneously.

**Perform Walkthroughs of the Accounting System**

In a **walkthrough**, the auditor selects one or a few documents of a transaction type and traces them from initiation through the entire accounting process. At each stage of processing, the auditor makes inquiries, observes activities, and examines completed documents and records. Walkthroughs conveniently combine observation, documentation, and inquiry to assure that the controls designed by management have been implemented.

After obtaining an understanding of internal control, the auditor makes a preliminary **assessment of control risk** as part of the auditor’s overall assessment of the risk of material misstatement. This assessment is a measure of the auditor’s expectation that internal controls will prevent material misstatements from occurring or detect and correct them if they have occurred.

The starting point for most auditors is the assessment of entity-level controls. By nature, entity-level controls, such as many of the elements contained in the control environment, risk assessment, and monitoring components, have an overarching impact on most major types of transactions in each transaction cycle. For example, ineffective boards of directors or management’s failure to have any process to identify, assess, or manage key risks, have the potential to undermine controls for most of the transaction-related audit objectives. Thus, auditors generally assess entity-level controls before assessing transaction specific controls. Once auditors determine that entity-level controls are designed and placed in operation, they next make a preliminary assessment for each transaction-related audit objective for each major type of transaction in each transaction cycle. For example, in the sales and collection cycle, the types of transactions usually involve sales, sales returns and allowances, cash receipts, and the provision for and write-off of uncollectible accounts. The auditor also makes the preliminary assessment for controls affecting audit objectives for balance sheet accounts and presentations and disclosures in each cycle.

1. Gather information to assess fraud risks

SAS 99 provides guidance to auditors in assessing the risk of fraud. Auditors must maintain a level of professional skepticism as they consider a broad set of information, including fraud risk factors, to identify and respond to fraud risk. Auditing standards state that, in exercising **professional skepticism**, an auditor “*neither assumes that management is dishonest nor assumes unquestioned honesty*.” In assessing fraud risk, auditor should have;

* *A questioning mind.*
* *Critically evaluate audit evidence.*

*The sources of information for assessing fraud risks include;*

* *Communication among the audit team.*
* *Inquiry from management.*

SAS 99 requires the auditor to make specific inquiries about fraud in every audit. Inquiries of management and others within the company provide employees with an opportunity to tell the auditor information that otherwise might not be communicated. Moreover, their responses to the auditor’s questions often reveal information on the likelihood of fraud.

* *Risk factors*

SAS 99 requires the auditor to evaluate whether fraud risk factors indicate incentives or pressures to perpetrate fraud, opportunities to carry out fraud, or attitudes or rationalizations used to justify a fraudulent action.

* *Analytical procedures*

Auditors must perform analytical procedures during the planning and completion phases of the audit to help identify unusual transactions or events that might indicate the presence of material misstatements in the financial statements.

1. Develop audit plan and audit program.