Prospective Client Acceptance

* Requires that the client authorize you to speak to predecessor
* Make the following inquiries
  + Information that might bear on the integrity of management
  + Disagreements with management about accounting policies, auditing procedures, or other similarly significant matters
  + Communications to those charged with governance regarding fraud and noncompliance with laws or regulations by the entity
  + Communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control
  + The predecessor auditor’s understanding about the reasons for the change of auditors
* Procedures for Evaluating a Prospective Client
  + Obtain and review available financial information (annual reports, interim financial statements, income tax returns, etc).
  + Inquire of third parties about any information concerning the integrity of the prospective client and its management. Such inquiries should be directed to the prospective client’s bankers and attorneys, credit agencies, and other members of the business community who may have such knowledge.
  + Communicate with the predecessor auditor about whether there were any disagreements about accounting principles, audit procedures, or similar significant matters
  + Consider whether the prospective client has any circumstances that will require special attention or that may represent unusual business or audit risks, such as litigation or going concern issues
  + Determine if the firm is independent of the client and able to provide the desired service
  + Determine if the firm has the necessary technical skills and knowledge of the industry to complete the engagement
  + Determine if acceptance of the client would violate any applicable regulatory agency requirements or the Code of Professional Conduct

Preliminary Engagement Activities

* Three Preliminary Engagement Activities
  + Determining the audit engagement team requirements
  + Ensuring that the audit team and audit firm are in compliance with ethical and independence requirements, and
  + Establishing an understanding with the client
* Determine the Audit Engagement Team Requirements
  + The firm needs to ensure that their auditors have the proper degree of technical training and proficiency given the circumstances of the client
  + Some factors to consider
    - Engagement size and complexity
    - Level of risk
    - Any special expertise
    - Personnel availability
    - Timing of the work to be performed

Assess Compliance with Ethical and Independence Requirements

* A Public Accounting firm should establish policies and procedures to ensure that persons at all organizational levels within the firm meet the profession’s ethical requirements, including maintaining independence in accordance with Rule 101 of the Code of Professional Conduct
* The firm should document compliance with this policy by having all personnel complete an annual independence questionnaire or report.
* E.g. Unpaid fees, having ownership or family involved with the company, no consulting services, etc.

Establish an Understanding with the Client

* Establish an understanding with the client about the terms of the engagement
* Reduces the risk that either party may be misinterpret what is expected or required of the other party.
* Engagement Letter
  + Objectives of the engagement
  + Management’s responsibilities
  + Auditor’s responsibilities
  + Limitations of the engagement
* Three topics to discuss
  + The engagement letter
  + Using the work of the internal auditors
  + Role of the audit committee
* Engagement Letter
  + An engagement letter is used to formalize the arrangements reached between the auditor and the client. This letter serves are a contract, outlining the responsibilities of both parties and preventing misunderstandings between the two parties
  + May include
    - Arrangements involving the use of specialists or internal auditors
    - Any limitation of the liability of the auditor or client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management or alternative dispute resolution procedures
    - Additional services to be provided relating to regulatory requirements
    - Arrangements regarding other services (e.g. assurance, tax, or consulting services)

Using Internal Auditors

* The auditor first needs to obtain an understanding of the internal audit function, including information about the activities that it performs.
* Determine whether any of these activities are relevant to the audit of the financial statements
* The internal auditors’ work may affect the nature, timing, and extent of the audit procedures performed by the independent auditor
* If the internal auditors are competent and objective, the independent auditor may use the internal auditors’ work in these areas to reduce the scope of audit work.
* The materiality of the account balance or class of transactions and its related audit risk may also determine how much the independent auditor can rely on the internal auditors’ work.
* You should always supervise, review, evaluate, and test their work.

The Role of the Audit Committee

* An audit committee is a subcommittee of the board of directors that is responsible for the financial reporting and disclosure process.
* Under section 301 of SOX , the audit committee of a public company has the following requirements:
  + Each member of the audit committee must be a member of the board of directors and shall remain independent. “Independent” is defined as not receiving, other than for service on the audit committee, any consulting, advisory, or other compensatory fee and not being affiliated with the company
  + The audit committee is directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company.
  + The audit committee must preapprove all audit and nonaudit services provided by the auditor
  + The audit committee must establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal control, and auditing
  + Each audit committee member must have the authority to engage independent counsel or other advisors, as determines necessary to carry on its duties

Audit Plan and Strategy

* Engagement planning involves all the issues that auditor
* The audit plan is more detailed than the audit strategy. Auditor documents a description of the nature, timing, and extent of the planned audit procedures to be used in order to comply with auditing standards. How to conduct the audit in an effective and efficient manner.
* Additional Steps
  + Assess business risks
  + Establish materiality
  + Consider multilocations
  + Assess the need for specialists
  + Assess the possibility of illegal acts
  + Identify related parties
  + Consider additional value-added services

Audit Plan & Strategy

* Assess Business Risks
  + Identify those business risks that may result in material misstatements.
  + How does the entity respond to those business risks and ensure that those responses have been adequately implemented?
* Establish Materiality
  + A matter of professional judgment
  + The auditor establishes a level of planning (or overall) materiality for evaluating the financial statements as a whole
  + Auditor also establishes tolerable misstatement – an amount of planning materiality that is allocated to specific accounts (i.e. A/R) or classes of transactions (i.e. sales transactions).
* Multilocations or Business Units
  + The auditor is to determine which locations or business units are to be audited and the extent of audit procedures to be performed at the selected locations or business units.
  + Related to AS 9
* Assess the Need for Specialists
  + Auditor’s specialist as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence.
  + You should evaluate the competence and objectivity of the specialist, audit the inputs used by the specialist (e.g. census data for actuaries) and reconcile the output (e.g., an estimate should be found in the financial statements or disclosures), and review the specialist’s work for reasonableness, including the reasonableness of assumptions.
* Assess the Possibility of Illegal Acts
  + Illegal acts refers to violation of laws or governmental regulations.
  + Auditing standards distinguish between illegal acts that have direct and material effects on the financial statements and those that have material but indirect effects.
  + It is the auditor’s responsibility to detect illegal acts that have direct and material effect on the financial statements.
  + If it is found to of occurred, the auditor should consider its implications for other aspects of the audit, particularly the reliability of management representations. Inform the audit committee.
* Identify Related Parties
  + Affiliates of the enterprise; investments, trusts, pension, profit-sharing trusts, principal owners, management, immediate family, others who can influence management, etc.
  + How to find out
    - Review the minutes of the BOD and executive or operating committees for information about material transactions authorized or discussed at their meetings.
    - Review conflict-of-interest statements obtained by the company from management
    - Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships
    - Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of a reporting period
    - Review confirmations of loans receivables and payable for indications of guarantees. If guarantees are identified, determine their nature and the relationships of the guarantor to the entity.
* Consider Additional Value-Added Services
  + Provide strengths and weaknesses to BOD and management
  + Assurance services, risk assessment, business performance measurements, and electronic commerce.
* Document the Overall Audit Strategy, Audit Plan, and Prepare Audit Programs
  + Document decisions about the nature, timing, and extent of audit tests. The auditor records how the client is managing its risks (i.e., through internal control processes) and then documents the effects of the risk and controls on the planned audit procedures.

Supervision of the Audit (AS13)

* The engagement partner has the overall responsibility for the engagement and its performance and should supervise the audit engagement team so that the work is performed as directed and supports the conclusions reached.
  + Inform engagement team members of their responsibilities, including
    - The objectives of the procedures that they are to perform;
    - The nature, timing, and extent of procedures they are to perform; and
    - Matters that could affect the procedures to be performed or the evaluation of the results of those procedures
  + Direct engagement team members to bring any significant accounting and auditing issues they identify to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine appropriate actions
  + Review the work of engagement team members to evaluate whether
    - The work was performed and documented;
    - The objectives of the procedures were achieved; and
    - The results of the work support the conclusions reached

Types of Audit Tests

* Risk Assessment Procedures
* Tests of Control
* Substantive Procedures

Risk Assessment Procedures

* Obtain an understanding of the entity and its environment, including its internal control. Inquiries of management and others, preliminary analytical procedures, and observation and inspection

Test of Controls

* Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the relevant assertion level. E.g.
  + Inquiries of appropriate management, supervisory, and staff personnel
  + Inspection of documents, reports, and electronic files
  + Observation of the application of specific controls
  + Walkthroughs, which involve tracing a transaction from its origination to its inclusion in the financial statements through a combination of audit procedures including inquiry, observation, and inspection
  + Reperformance of the application of the control by the auditor

Substantive Procedures

* Designed to detect material misstatements in a transaction class, account balance, and disclosure component of the financial statements.
  + Tests of Details
    - Categorized into two types:
      * Substantive Tests of Transactions
        + Test for errors or fraud in individual transactions
        + Gives evidence about occurrence, completeness, and accuracy assertions
      * Tests of Details of Account Balances and Disclosures
        + Items that are contained in the ending financial statement account balances and disclosures. Test A/R
        + Send confirmations to a sample of customers in order to gather evidence about the existence assertion
  + Substantive Analytical Procedures
    - Evaluation of financial information through analysis of plausible relationships (e.g., examination of trends and ratios) among both financial and nonfinancial data
    - Identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
* Dual-Purpose Tests