CPA REVIEW SCHOOL OF THE PHILIPPINES

Manila

AUDITING THEORY

AUDIT PLANNING

Related PSAs: PSA 300, 310, 320, 520 and 570

Appointment of the Independent Auditor

Early appointment of the independent auditor has many advantages to both the auditor and his client. Early appointment enables the auditor to plan his work so that it may be done expeditiously and to determine the extent to which it can be done before the balance sheet date.

Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, he should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, he should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

PSA 300 - Planning

The first standard of fieldwork (performance standards) states that:

"The work is to be adequately planned and assistants, if any, are to be properly supervised."

The auditor should plan the audit work so that the audit will be performed in an effective manner.

"**Planning**" means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit. The auditor plans to perform the audit in an efficient and timely manner.

Importance of Adequate Planning

Adequate planning of the audit work helps to ensure that:
1) Appropriate attention is devoted to important areas of the audit;
2) Potential problems are identified; and
3) The work is completed expeditiously.

Planning also assists in proper:
1) Assignment of work to assistants; and
2) Coordination of work done by other auditors and experts.

Extent of Planning

The extent of planning will vary according to the following:
1) Size of the entity;
2) Complexity of the audit; and
3) Auditor's experience with the entity and knowledge of the business.

The Overall Audit Plan

The auditor **should** develop and document an overall audit plan describing the expected scope and conduct of the audit.

While the record of the overall audit plan will need to be sufficiently detailed to guide the development of the audit program, its precise form and content will vary depending on the following:
1) Size of the entity;
2) Complexity of the audit; and
3) Specific methodology and technology used by the auditor.

Matters to be considered by the auditor in developing the overall audit plan include:

Knowledge of the Business

- General economic factors and industry conditions affecting the entity's business.
- Important characteristics of the entity, its business, its financial performance and its reporting requirements including changes since the date of the prior audit.

- The general level of competence of management.

Understanding the Accounting and Internal Control Systems

- The accounting policies adopted by the entity and changes in those policies.
- The effect of new accounting or auditing pronouncements.
- The auditor's cumulative knowledge of the accounting and internal control systems and the relative emphasis expected to be placed on tests of control and substantive procedures.

Risk and Materiality

- The expected assessments of inherent and control risks and the identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- The possibility of material misstatement, including the experience of past periods, or fraud.
- The identification of complex accounting areas including those involving accounting estimates.

Nature, Timing and Extent of Procedures

- Possible change of emphasis on specific audit areas.
- The effect of information technology on the audit.
- The work of internal auditing and its expected effect on external audit procedures.

Coordination, Direction, Supervision and Review

- The involvement of other auditors in the audit of components, for example, subsidiaries, branches and divisions.
- The involvement of experts.
- The number of locations.
- Staffing requirements.

Other Matters

- The possibility that the going concern assumption may be subject to question.
- Conditions requiring special attention, such as the existence of related parties.
- The terms of the engagement and any statutory responsibilities.
- The nature and timing of reports or other communication with the entity that are expected under the engagement.

The Audit Program

The auditor **should** develop and document an audit program setting out the <u>nature</u>, <u>timing</u> and <u>extent</u> of planned audit procedures required to implement the overall audit plan.

The audit program serves as a:
1) Set of instructions to assistants involved in the audit; and
2) Means to control and record the proper execution of the work.

The audit program also contains:
1) The audit objectives for each area; and
2) A time budget in which hours are budgeted for the various audit areas or procedures.

In preparing the audit program, the auditor would consider the following:
1) Specific assessments of inherent and control risks and the required level of assurance to be provided by substantive procedures;
2) Timing of tests of controls and substantive procedures;
3) Coordination of any assistance expected from the entity, the availability of assistants and the involvement of other auditors or experts; and
4) Other matters considered by the auditor in developing the overall audit plan need to be considered in more detail during the development of the audit program.

Changes to the Overall Audit Plan and Audit Program

The overall audit plan and the audit program should be revised as necessary during the course of the audit. Planning is continuous throughout the engagement because of changes in conditions or unexpected results of audit procedures. The reasons for significant changes would be recorded.

PSA 310 - Knowledge of Business

In performing an audit of financial statements, the auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.

Required Level of Knowledge

The auditor's level of knowledge for an engagement would include:

- a general knowledge of the economy and the industry within which the entity operates, and
- a more particular knowledge of how the entity operates.

The level of knowledge required by the auditor would, however, ordinarily be *less than* that possessed by management.

Obtaining the Knowledge

Prior to accepting an engagement, the auditor would obtain:

- a preliminary knowledge of the industry and of the ownership,
- management and operations of the entity to be audited, and
- would consider whether a level of knowledge of the business adequate to perform the audit can be obtained.

Following acceptance of the engagement, further and more detailed information would be obtained. To the extent practicable, the auditor would obtain the required knowledge at the start of the engagement. As the audit progresses, that information would be assessed and updated and more information would be obtained.

For continuing engagements, the auditor would:

- update and reevaluate information gathered previously, including information in the prior year's working papers.
- also perform procedures designed to identify significant changes that have taken place since the last audit.

The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:

- Previous experience with the entity and its industry.
- Discussion with people with the entity (for example, directors and senior operating personnel).
- Discussion with internal audit personnel and review of internal audit reports.
- Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
- Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers, suppliers, competitors).
- Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers, financial newspapers).
- Legislation and regulations that significantly affect the entity.
- Visits to the entity's premises and plant facilities.
- Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

Using the Knowledge

A knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:

- Assessing risks and identifying problems.
- Planning and performing the audit effectively and efficiently.
- Evaluating audit evidence.
- Providing better service to the client.

The auditor makes judgments about many matters throughout the course of the audit where knowledge of the business is important. For example:

- Assessing inherent risk and control risk.
- Considering business risks and management's response thereto.
- Developing the overall audit plan and the audit program.
- Determining a materiality level and assessing whether the materiality level chosen remains appropriate.
- Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.
- Evaluating accounting estimates and management representations.
- Identifying areas where special audit consideration and skills may be necessary.
- Identifying related parties and related party transactions.
- Recognizing conflicting information (for example, contradictory representations).
- Recognizing unusual circumstances (for example, fraud and noncompliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results).
- Making informed inquiries and assessing the reasonableness of answers.
- Considering the appropriateness of accounting policies and financial statement disclosures.

The auditor should ensure that assistants assigned to an audit engagement obtain sufficient knowledge of the business to enable them to carry out the audit work delegated to them.

To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

<u>PSA 320 – Audit Materiality</u>

The auditor should consider materiality and its relationship with audit risk when conducting an audit.

"Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a <u>threshold or cut-off point</u> rather than being a primary qualitative characteristic which information must have if it is to be useful."

The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures.

Materiality should be considered by the auditor when:

(a) determining the nature, timing and extent of audit procedures; and
(b) evaluating the effect of misstatements.

The Relationship Between Materiality and Audit Risk

There is an **inverse** relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa.

Materiality and Audit Risk in Evaluating Audit Evidence

The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of:

- a change in circumstances; or
- because of a change in the auditor's knowledge as a result of the audit.

Evaluating the Effect of Misstatements

In evaluating the fair presentation of the financial statements the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.

The aggregate of uncorrected misstatements comprises:

(a) specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and
(b) the auditor's best estimate of other misstatements which cannot be specifically identified (i.e., projected errors).

If the auditor concludes that the misstatements may be material the auditor needs to:

- consider reducing audit risk by extending audit procedures; or
- requesting management to adjust the financial statements.

If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with PSA 700 "The Auditor's Report on Financial Statements."

MULTIPLE CHOICE QUESTIONS

1. The development of a general strategy and a detailed approach for the expected nature, timing, and extent of audit refers to :
   a. Supervision b. Audit procedures c. Directing d. Planning

2. The auditor should consider the nature, extent, and timing of the work to be performed and should prepare a written audit program for every audit. Which audit standard is most closely related to this requirement?
   a. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
   b. In all matters relating to the assignment, an independent mental attitude is to be maintained by the auditor(s).
   c. Due professional care is to be exercised in the planning and performance of the audit and preparation of the report.
   d. The work is to be adequately planned and assistants, if any, are to be properly supervised.

3. Which of the following would a successor auditor normally perform after acceptance of an audit client?
   a. Inquiry of predecessor auditor regarding the client.
   b. Review the SEC filings of the client.
   c. Inquiry of bankers regarding the client.
   d. Review of predecessor auditor working papers.

4. To obtain an understanding of a continuing client's business in planning an audit, an auditor most likely would
   a. Perform tests of details of transactions and balances.
   b. Review prior-year working papers and the permanent file for the client.
   c. Read specialized industry journals.
   d. Reevaluate client's internal control environment.

5. Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?
   a. A flowchart or narrative of the information system describing the recording and classification of transactions for financial reporting.
   b. An audit program setting forth in detail the procedures necessary to accomplish the engagement's objectives.
   c. A planning memorandum establishing the timing of the audit procedures and coordinating the assistance of entity personnel.
   d. An internal control questionnaire identifying policies and procedures that assure specific objectives will be achieved.

6. Which of the following procedures would an auditor most likely perform in planning a financial statement audit?
   a. Inquiring of the client's legal counsel concerning pending litigation.
   b. Comparing the financial statements to anticipated results.
   c. Examining computer generated exception reports to verify the effectiveness of internal controls.
   d. Searching for unauthorized transactions that may aid in detecting unrecorded liabilities.

7. Analytical procedures used in planning an audit should focus on
   a. Reducing the scope of tests of controls and substantive tests.
   b. Providing assurance that potential material misstatements will be identified.
   c. Enhancing the auditor's understanding of the client's business.
   d. Assessing the adequacy of the available evidential matter.

8. Analytical procedures, which means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts, are not required to be applied
   a. At the planning stage of the audit
   b. Overall review stage of the audit
   c. As substantive procedures
   d. None of the above

9. Which of the following statements is correct concerning analytical procedures?
   a. Analytical procedures usually involve comparisons of ratios developed from recorded amounts to assertions developed by management.
   b. Analytical procedures used in planning an audit generally use data aggregated at a high level.
   c. Analytical procedures can replace tests of controls in gathering evidence to support the assessed level of control risk.
   d. Analytical procedures are more efficient, but not more effective, than tests of details and transactions.

10. Which of the following is an effective audit planning and control procedures that helps prevent misunderstandings and inefficient use of audit personnel?
    a. Make copies, for inclusion in the working papers, of those client supporting documents examined by the auditor.
    b. Provide the client with copies of the audit programs to be used during the audit.
    c. Arrange a preliminary conference with the client to discuss audit objectives, fees, timing, and other information.
    d. Arrange to have the auditor prepare and post any necessary adjusting or reclassification entries prior to final closing.

11. Which of the following is an aspect of scheduling and controlling the audit engagement?
    a. Including in the audit program a column for estimated and actual time.
    b. Performing audit work only after the client's books of account have been closed for the period under examination.
    c. Writing a conclusion in individual working papers indicating how the results of the audit will affect the auditor's report.
    d. Including in the engagement letter an estimate of the minimum and maximum audit fee.

12. Which of the following is an engagement attribute for an audit of an entity that processes most of its financial data in electronic form without any paper documentation?
    a. Discrete phases of planning, interim, and year-end field work.
    b. Increased effort to search for evidence of management fraud.
    c. Performance of audit tests on a continuous basis.
    d. Increased emphasis on the completeness assertion.

13. Which of the following statements is not correct about materiality?
    a. The concept of materiality recognizes that some matters are important for fair presentation of financial statements in conformity with GAAP, while other matters are not important.
    b. An auditor considers materiality for planning purposes in terms of the largest aggregate level of misstatements that could be material to any one of the financial statements.
    c. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.
    d. An auditor's consideration of materiality is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

14. The risk that the assertion contains material misstatements that, when aggregated with misstatements in other assertions, could make the entire financial statements materially misstated is:
    a. Individual audit risk
    b. Inherent risk
    c. Control risk
    d. Detection risk

15. Incremental risk is the increased risk that errors may not be detected at the balance sheet date because:
    a. Audit procedures were performed at an interim date
    b. Inherent risk was assessed too low.
    c. Analytical procedures were not performed.
    d. Detection risk was set too high a level.

QUIZZERS

PSA 300 - Planning

1. Adequate planning of the audit work helps the auditor of accomplishing the following objectives, except:
    a. Gathering of all corroborating audit evidence.
    b. Ensuring that appropriate attention is devoted to important areas of the audit.
    c. Identifying the areas that need a service of an expert.
    d. The audit work is completed efficiently.

2. The extent of planning will vary according to any of the following, except:
    a. Size of the audit client.
    b. Auditor's experience with the entity and knowledge of the business.
    c. The nature and complexity of the audit engagement
    d. The assessed level of control risk.

3. Which of the following is least likely considered by the auditor in developing the overall audit plan?
    a. Understanding of the accounting and internal control systems.
    b. Relevant risk and materiality.
    c. The involvement of other auditors in the audit of major component of financial statements
    d. The general level of competence of audit assistants.

4. Which of the following is not considered by the CPA when he makes an overall audit plan?
    a. Identification of complex accounting areas including those involving accounting estimates.
    b. The information technology used by the client.
    c. The content of the representation letters.
    d. The nature and timing of reports or other communication with the entity that are expected under the engagement.

5. Audit plan should

	A	B	C	D
A. Precede action	Yes	No	Yes	No
B. Be fixed	Yes	No	No	Yes
C. Be cost beneficial	Yes	Yes	Yes	Yes

6. Which of the following least likely affect the form and content of the overall audit plan?
    a. Complexity of the audit engagement.
    b. Methodology and technology used by the auditor.
    c. The entity's form of business organization.
    d. The size of the entity.

7. The audit program should contain the following, except:
    a. Audit objective
    b. Time budget for the various audit areas
    c. Set of planned audit procedures
    d. The combined assessed level of inherent and control risk

PSA 310 - Knowledge of Business

8. Which of the following will most likely help the auditor to identify and understand the events, transactions and practices of his audit client?
    a. Obtaining a sufficient knowledge of the business of his client.
    b. Understanding of accounting and internal control.
    c. Testing control policies and procedures.
    d. Obtaining a representation letter from the client management.

9. The auditor should have or obtain a knowledge of the client's business sufficient to:
    a. Evaluate whether the financial statements are materially misstated.

b. Document material weaknesses in accounting and internal control systems.
c. Identify and understand events, transactions and practices that may have effect on financial statements.
d. Have an overall evaluation of whether financial assertions are fairly presented in the financial statements.

10. The auditor is not expected to have
  a. A particular knowledge of the economy and the industry within which the entity operates.
  b. A particular knowledge of how the entity operates.
  c. A level of knowledge of business ordinarily less than that possessed by management.
  d. A knowledge of business which is used in assessing inherent and control risk.

11. The auditor obtains knowledge of client's business

	A	B	C	D
Prior to acceptance of engagement	No	No	Yes	Yes
Planning stage of the audit	Yes	Yes	Yes	No
Testing of transactions stage	No	Yes	Yes	Yes

12. Understanding the business and using this information appropriately assists the auditor in, except
  a. Deciding whether to do tests of controls.
  b. Evaluating audit evidence.
  c. Assessing risks and identifying potential problems.
  d. Planning and performing the audit effectively and efficiently.

13. Which of the following is the ultimate concern of the knowledge about the business?
  a. Consideration of how it affects the financial statements taken as a whole.
  b. Assists the auditor in enforcing quality control procedures.
  c. To assure that sufficient audit evidence is obtained.
  d. It assists in determining the type of audit report to be issued.

14. A knowledge of the business is a frame of reference within which the auditor exercises professional judgment. This assists the auditor in carrying out the following objectives, except:
  a. Assessing risks and identifying problems.
  b. Evaluating audit evidence.
  c. Determining the audit opinion to be expressed.
  d. Planning and performing the audit effectively and efficiently.

15. Throughout the course of the audit, the auditors make judgment about many matters where knowledge of the business is important. These procedures do not include:
  a. Evaluating accounting estimates and management representations.
  b. Identifying related parties and related party transactions.
  c. Assessing inherent and control risks.
  d. Assessing the appropriateness of using statistical sampling instead of judgmental sampling.

<u>PSA 570 – Going Concern</u>

16. Which of the following factors is inappropriately relevant to the management's assessment of the going concern assumption?
  a. The degree of uncertainty associated with the outcome of an event or condition decreases significantly the further into the future of judgment being made about the outcome of an event or condition.
  b. Any judgment about the future is based on information available at the time at which the judgment is made.
  c. The size and complexity of the entity, and the nature and conditions of its business affect the judgment regarding the outcome of events or conditions.
  d. Subsequent events can contradict a judgment which was reasonable at the time it was made.

17. Which of the following may not cast significant doubt about the going concern assumption of an entity.
  a. The entity heavily used equity financing for investment in permanent assets.
  b. Non-compliance with capital or other statutory requirements.
  c. Pending legal or regulatory proceeding against the entity that may, if successful, result in claims that are unlikely to be satisfied.
  d. Changes in legislation or government policy expected to adversely affect the entity.

18. When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:
    a. Review management's plans for future actions based on its going concern assessment.
    b. Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors.
    c. Seek written representations from management regarding its plans for future action.
    d. All of the above.

19. Which of the following proposed actions may mostly mitigate the going concern problem of an entity?
    a. Rescheduling of loan payments.
    b. More vigorous business expansion.
    c. Acquiring asset replacement using short-term loans.
    d. Increasing the amount of cash dividends to be paid.

20. The following are related to the auditor's responsibility to assess the ability of the company to continue as a going concern?
    I. The auditor should consider the appropriateness of the management's use of the going concern assumption in the preparation of the financial statements.
    II. The auditor is to consider whether there are material uncertainties about the entity's ability to continue as a going concern that needs to be disclosed in the financial statements.
    III. The absence of any reference to going concern uncertainty in the auditor's report is viewed as a guarantee as to the entity's ability to continue as a going concern.

    Which of the foregoing inappropriately describe(s) the auditor's responsibility?
    a. I only   b. I and II only   c. II only   d. III only

21. The auditor consider events and condition relating to the going concern assumption during the planning stage in order to:
    a. Help management do action that may mitigate its going concern problems.
    b. Identifying the areas of accounting and internal control systems that need tests of control.
    c. To have a timely discussion with management and a review of management's plans and resolutions of any identified going concern issues.
    d. In order to shorten assessment period.

22. If adequate disclosure is not made by the entity regarding substantial doubt about its ability to continue as a going concern, the auditor should include in his report specific reference to the substantial doubt as to ability of the company to continue as a going concern and should express:
    a. Unqualified opinion with explanatory paragraph
    b. A subject to qualified opinion or adverse opinion.
    c. Either an "except for" qualified opinion or an adverse opinion.
    d. A disclaimer of opinion.

23. If the auditor believes that the entity will not be able to continue as a going concern and the financial statements are prepared on a going concern basis, the auditor's report should include:
    a. Unqualified opinion with explanatory paragraph.   c. Adverse opinion.
    b. Qualified opinion.   d. Disclaimer of opinion.

24. If the auditor believes that management should extend its assessment but the latter refuses to do so, the auditor should:
    a. Rectify the lack of analysis by management.
    b. Extend his audit procedures to obtain sufficiently appropriate evidence regarding the use of the going concern assumption.
    c. Emphasize this matter in the audit report.
    d. Consider a modification of the report as a result of the limitation in the scope of the auditor's work.

25. The management denied the auditor's request that the management has to extend its assessment of its going concern ability. However, the auditor's other procedures are sufficient to assess the appropriateness of management use of the going concern assumption in the preparation of the financial statements. he auditor should issue:
    a. Unqualified opinion   c. Adverse opinion
    b. Unqualified opinion with explanatory paragraph   d. Disclaimer of opinion

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