Audit Planning, Types of Audit Tests and Materiality

Learning Objectives

Upon completion of this chapter you will

LO1 Understand the auditor's requirements for client acceptance and continuance.

LO2 Understand the steps that are involved in the preliminary engagement activities.

LO3 Know what is required to establish an understanding with the entity.

LO4 Know the types of information that are included in an engagement letter.

LO5 Understand how the external auditor may use the work of the internal audit function.

LO6 Know how the external auditor relates to those charged with governance.

LO7 Know the steps that are performed in planning an audit engagement.

LO8 Understand the importance of supervision to the planning and conduct of the audit.

LO9 Know the types of audit tests.

LO10 Understand the concept of materiality.

LO11 Know the steps to applying materiality in an audit.

LO12 Apply the materiality steps to an example (EarthWear).

Relevant Accounting and Auditing Pronouncements

IESBA, Code of Ethics for Professional Accountants

ISA 210, Agreeing the Terms of Audit Engagements

ISA 220, Quality Control for an Audit of Financial Statements

ISA 230, Audit Documentation

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements

ISA 260, Communication with Those Charged with Governance

ISA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

ISA 300, Planning an Audit of Financial Statements

ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

ISA 320, Materiality in Planning and Performing an Audit

ISA 330, The Auditor's Responses to Assessed Risks

ISA 450, Evaluation of Misstatements Identified during the Audit

ISA 500, Audit Evidence

ISA 510, Initial Audit Engagements – Opening Balances

ISA 520, Analytical Procedures

ISA 530, Audit Sampling

ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

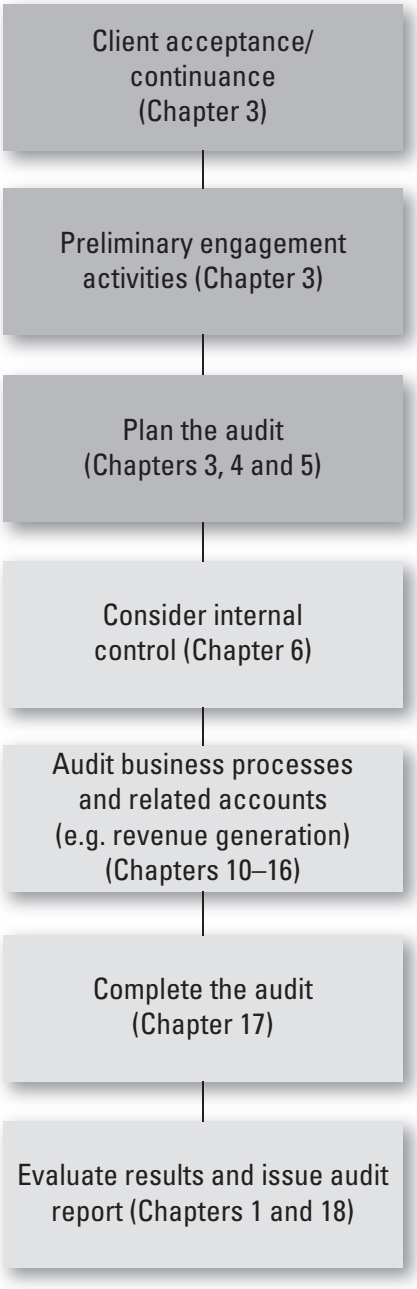
ISA 550, Related Parties

ISA 580, Written Representations

ISA 610, Using the Work of Internal Auditors

ISA 620, Using the Work of an Auditor's Expert

Major Phases of an Audit



Auditing standards require that the audit be properly planned. Planning an audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes risk assessment procedures and planned audit responses to the risks of material misstatement. If the audit is not properly planned, the auditor may issue an incorrect audit report or conduct an inefficient audit. The audit starts with the initial appointment or reappointment of the auditor by the entity or audit committee. Next, the auditor performs a number of activities that go into developing an overall audit strategy.

This chapter covers the following phases of the audit identified in Chapter 1, Figure 1–3:

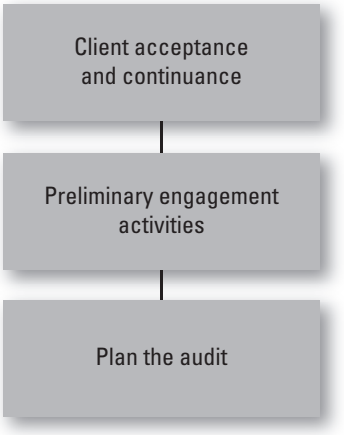
- Client acceptance and continuance.
- Preliminary engagement activities.
- Planning the audit.

It then covers the major types of audit tests and the concept of materiality.

Client Acceptance and Continuance

LO1 The first phase of the audit process that relates to audit planning is client acceptance and continuance (see Figure 3–1). The degree of effort that goes into evaluating a new client is normally much greater than the decision to continue with an existing client. With a continuing client the auditor possesses extensive knowledge about the entity and its environment.

Figure 3–1 The Phases of an Audit that Relate to Audit Planning



Prospective Client Acceptance

Audit firms should investigate a prospective client prior to accepting an engagement. Table 3–1 lists procedures that a firm might conduct to evaluate a prospective client. Performance of such procedures would normally be documented in a memo or by completion of an entity acceptance questionnaire or checklist.

Table 3–1 Procedures for Evaluating a Prospective Client

1. Obtain and review available financial information (annual reports, interim financial statements, income tax returns, etc.).
2. Inquire of third parties regarding any information concerning the integrity of the prospective client and its management. (Such inquiries should be directed to the prospective client's bankers and lawyers, credit agencies and other members of the business community who may have such knowledge.)
3. Communicate with the predecessor auditor about whether there were any disagreements about accounting policies, **audit procedures** or similar significant matters.
4. 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.
5. Determine if the firm is independent of the entity and able to provide the desired service.
6. Determine if the firm has the necessary technical skills and knowledge of the industry to complete the engagement.
7. Determine if acceptance of the entity would violate any applicable regulatory or ethical requirements such as those in the IESBA Code of Ethics for Professional Accountants.

When the prospective client has previously been audited, the successor auditor makes certain inquiries of the predecessor auditor before accepting the engagement. Because an auditor is not allowed to disclose confidential client information without the entity's consent, the prospective client must

authorize the predecessor auditor to respond to the successor's requests for information. (Chapter 19 discusses the confidentiality principle in the IESBA Code of Ethics for Professional Accountants.) The successor auditor should make the following inquiries of the predecessor auditor:

- 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 non-compliance with laws or regulations by the entity.
- Communications to management and those charged with governance regarding significant deficiencies in internal control.
- The predecessor auditor's understanding about the reasons for the change of auditors.

Such inquiries of the predecessor auditor may help the successor auditor determine whether to accept the engagement. Subject to any legal or regulatory constraints in the jurisdiction, the predecessor auditor ordinarily advises the successor auditor whether there are any professional reasons not to accept the engagement.[i]

In the unusual case where the prospective client refuses to permit the predecessor auditor to respond, the successor auditor should have reservations about accepting the entity. Such a situation raises serious questions about management's motivations and integrity. In addition, if the entity has unusual business risks such as possible going-concern issues, the auditor is not likely to accept the prospective client because the auditor's own business risk may be too high.

After accepting the engagement, the successor auditor may need information on beginning balances in order to issue an unmodified opinion. The successor auditor would ordinarily request that the entity authorizes the predecessor auditor to permit a review of his or her working papers. In most instances, the predecessor auditor will allow the successor auditor to make copies of any working papers of continuing interest (for example, details of selected balance sheet accounts).

If the client has not previously been audited, the audit firm might complete all the procedures listed in Table 3–1, except for the communication with the predecessor auditor. The auditor should review the prospective client's financial information and carefully assess the integrity of management, for example by communicating with the entity's bankers and lawyers, as well as other members of the business community. Larger audit firms may have full-time staff who complete background checks and monitor news of major clients.

Client Continuance

Audit firms should evaluate periodically whether to continue their relationship with current clients. This evaluation may take place at or near the completion of an audit or when some significant event occurs. Conflicts over accounting and auditing issues or disputes over fees may lead an audit firm to disassociate itself from the entity.

Preliminary Engagement Activities

There are generally three preliminary engagement activities: (1) determining the audit engagement team requirements; (2) ensuring that the audit team and audit firm are in compliance with ethical and independence requirements; and (3) establishing an understanding with the entity. LO2

Determine the Audit Engagement Team Requirements

Audit firms need to ensure that their engagements are completed by auditors having the proper degree of technical training and proficiency given the circumstances of the entity. Factors that should be considered in determining staffing requirements include engagement size and complexity, level of risk, any special expertise, personnel availability and timing of the work to be performed. For example, if the

engagement involves a high level of risk, the firm should staff the engagement with more experienced auditors. Similarly, if the audit involves a specialized industry (banking, insurance and so on) or if the entity uses sophisticated IT processing or holds financial instruments, the firm must ensure that members of the engagement team possess the requisite expertise. Generally, a time budget for the planned work is prepared in order to assist with the staffing requirements and to schedule the fieldwork.

Stop and Think: Suppose an entity held financial instruments (i.e. derivatives) that are accounted for using fair value accounting. What type of expertise would the audit team need?

Assess Compliance with Ethical and Independence Requirements

Auditing standards require that the auditor complies with the profession's ethical requirements, including those pertaining to independence. The legal and regulatory requirements in the jurisdiction and the IESBA Code of Ethics prescribe the relevant requirements (see Chapter 19).

Quality control standards require the firm to establish policies and procedures to ensure that persons at all organizational levels within the firm meet the ethical requirements, including maintaining independence. A firm ordinarily documents compliance with this policy by having all personnel complete an annual independence questionnaire or report. This questionnaire requests information about the auditor's financial or business relationships with the firm's clients. Under certain circumstances, family members' financial or business relationships are attributable to the auditor. For example, if the spouse of an auditor participating in an engagement was an accounting supervisor for the entity, independence would be considered impaired.

At the engagement level, the **engagement partner** should ensure that all individuals assigned to the engagement are independent of the entity. This can be accomplished by reviewing the annual independence reports for each member of the engagement team, or through the firm's independent database.

Another area of concern related to independence is overdue client fees. If an account receivable from an entity takes on the characteristics of a loan, the auditor's independence may be impaired. Many audit firms adopt a policy of not completing the current audit until all of the prior year's fees have been paid.

Finally, the firm must be concerned when it also provides consulting services for an audit client. While the performance of consulting services does not, in and of itself, impair independence, the audit team must remain objective when evaluating client activities that were developed by its firm's consultants. The IESBA Code of Ethics as well as legal and regulatory requirements in the jurisdiction limits the types of consulting services audit firms are permitted to provide to audit clients. See Chapter 19 for services prohibited by the IESBA Code of Ethics.

Establish an Understanding with the Entity

LO3 The auditor should establish an understanding with the entity about the terms of the engagement. This understanding reduces the risk that either party may misinterpret what is expected or required of the other party. The terms of the engagement, which are documented in the engagement letter, should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities and the limitations of the engagement. In establishing an understanding with the entity, three topics should be discussed: (1) the engagement letter; (2) using the work of the **internal auditors**; and (3) the role of those charged with governance.

The Engagement Letter

LO4 Auditing standards state that the auditor should document the understanding through a written communication with the entity. An **engagement letter** is used to formalize the arrangements reached between the auditor and the entity. This letter serves as a contract, outlining the responsibilities of both parties and preventing misunderstandings between the two parties. Exhibit 3–1 shows a sample engagement letter for EarthWear.

Exhibit 3–1 A Sample Engagement Letter: EarthWear Clothiers

Willis & Adams International 1 April 2013

Mr Chad Simon
Chair, Audit Committee
PO Box 787
Europolis

Dear Mr Simon

The purpose of this letter is to confirm our understanding of the terms of our engagement as independent auditors of EarthWear Clothiers (the 'Company').

The Objective and Scope of the Audit

You have requested that we audit the financial statements of EarthWear Clothiers, which comprise the consolidated statement of financial position as at 31 December 2013, and the consolidated statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Our Responsibilities and Limitations

We will conduct our audit in accordance with International Standards on Auditing (ISAs). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to error or fraud.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Management's Responsibilities

Our audit will be conducted on the basis that management acknowledges and understands that it has responsibility:

(a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;
(b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud; and

(*Continued*)

Exhibit 3–1 (continued)

(c) To provide us with:

(i) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that we may request from management for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

Fees

Our fees are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required. We estimate our fees for this audit of the financial statements will be €950,000, exclusive of out-of-pocket expenses. This estimate takes into account the agreed-upon level of preparation and assistance from company personnel; we will advise management should this not be provided or should any other circumstances arise which may cause actual time to exceed that estimate. Invoices rendered are due and payable upon receipt.

Reporting

We form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained. We expect to issue an audit report expressing an unmodified opinion that the financial statements are prepared, in all material respects, in accordance with International Financial Reporting Standards. The form and content of our report may need to be amended in the light of our audit findings.

This engagement letter reflects the entire agreement between us relating to the services covered by this letter. It replaces and supersedes any previous proposals, correspondence and understandings, whether written or oral. The agreements of EarthWear Clothiers and Willis & Adams International contained in this engagement letter will be effective for future years unless it is terminated, amended or superseded.

If you have any questions, please contact us.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

Very truly yours,

Willis & Adams International

M.J. Willis

M. J. Willis, Partner

Acknowledged and agreed on behalf of EarthWear Clothiers by

Chad Simon

Chair, Audit Committee

3 April 2013

The engagement letter for EarthWear is addressed to its chair of the **audit committee**. Generally, the engagement letter is addressed to management or those charged with governance depending on the governance structure of the entity and relevant laws and regulations (for example, the board of directors may be the addressee for entities that do not have an audit committee).

In addition to the items mentioned in the sample engagement letter in Exhibit 3–1, the engagement letter may include:

- Arrangements involving the use of experts or internal auditors.
- Explanation of the auditor's responsibilities to communicate audit matters of governance interest with those charged with governance.
- Additional services to be provided relating to regulatory requirements.
- Arrangements regarding other services (e.g. assurance, tax or consulting services).

Using the Work of the Internal Audit Function

When the entity has an **internal audit function** (IAF), the auditor may use the work of the IAF as evidence and request IAF assistance in conducting the audit (if direct assistance is not prohibited by law or regulation). The auditor first needs to obtain an understanding of the IAF, including information about the activities that it performs. The auditor next must determine whether any of these activities are likely to be relevant to the audit of the financial statements. In determining whether the work of the IAF can be used for purposes of the audit, the auditor must evaluate: LO5

- The extent to which the IAF's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
- The level of competence of the IAF.
- The application by the IAF of a systematic and disciplined approach, including quality control.

Table 3–2 presents factors that the auditor should consider when assessing the IAF.

Table 3–2 Factors for Evaluating the Reliability of the Internal Audit Function

Objectivity

- Whether the organizational status of the IAF, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgements (e.g. the IAF reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance).
- Whether the IAF is free of any conflicting responsibilities (e.g. having managerial or operational duties or responsibilities that are outside of the IAF).
- Whether those charged with governance oversee employment decisions related to the IAF.
- Whether there are any constraints or restrictions placed on the IAF by management or those charged with governance (e.g. in communicating the IAF's findings to the external auditor).
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

Competence

- Whether the IAF is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.

(*Continued*)

Table 3–2 (continued)

- Whether the internal auditors have adequate technical training and proficiency in auditing (e.g. the internal auditors' possession of relevant professional designations and experience).
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the IAF possesses the necessary skills to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

Systematic and Disciplined Approach

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programmes, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the IAF has appropriate quality control policies and procedures or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

The IAF's work may affect the nature, timing and extent of the audit procedures performed by the auditor. For example, as part of their regular work, the IAF may review, assess and monitor the entity's controls that are included in the accounting system. Similarly, part of the IAF work may include confirming accounts receivables or observing certain physical inventories. If the IAF is reliable, the auditor may use the IAF's work to reduce the scope of audit work. The materiality of the account balance and its related audit risk may also determine how much the auditor can rely on the IAF's work. When internal auditors work directly for the auditor, the auditor should supervise, review, evaluate and test their work.

The Role of Those Charged with Governance

LO6 **Those charged with governance** are person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. The external auditor needs to identify and communicate with those charged with governance.

The primary bodies responsible for governance are the supervisory board in countries with a two-tier board structure and the board of directors in countries with a single board structure. In larger or public entities an audit committee, a subgroup of those charged with governance, is established to oversee the external and internal auditing work carried out for the organization. (See Chapter 2 for a discussion of corporate governance and audit committees.)

At the outset of the audit the auditor establishes a constructive working relationship with those charged with governance in the entity. The auditor will meet or by other means communicate with those charged with governance before the engagement starts, to establish a communication process and discuss matters such as the auditor's responsibilities and significant accounting policies of the entity. The auditor's communication with those charged with governance also includes an overview of the planned scope and timing of the audit and the auditor's compliance with independence requirements. Those charged with governance also interact with the internal audit function.

The auditor is required to make a number of important communications of audit matters to those charged with governance during or at the end of the engagement. Chapter 17 covers them in detail.

Planning the Audit

Audit Strategy and Plan

LO7

Engagement **planning** involves all the issues the auditor should consider in developing an **overall audit strategy** for conducting the audit. In establishing the audit strategy, the auditor should determine the scope of the engagement, ascertain the reporting objectives to plan the timing of the audit, and consider the factors that will determine the focus of the engagement team's efforts. Developing the audit strategy helps the auditor determine what resources are needed to perform the engagement.

Once the overall audit strategy has been established, the auditor develops an **audit plan**. The audit plan is more detailed than the audit strategy. In the audit plan, the 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. Basically, the audit plan should consider how to conduct the audit in an effective and efficient manner.

The nature and extent of planning activities that are necessary depend on the size and complexity of the entity and the auditor's previous experience with the entity. The auditor should be guided by the results of the entity acceptance/continuance process, procedures performed to gain the understanding of the entity, and preliminary engagement activities. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit. Additional steps that should be performed include:

- Assess business risks.
- Establish **materiality**.
- Consider multi-locations.
- Assess the need for experts.
- Consider non-compliance with laws and regulations.
- Identify related parties.
- Consider additional value-added services.
- Document the overall audit strategy and audit plan.

Assess Business Risks

In Chapter 1, audit risk was defined as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. One way that the auditor reduces audit risk to an acceptably low level is by obtaining an understanding of the entity and its environment. Based on this understanding, the auditor identifies those business risks that may result in material misstatements. The auditor then evaluates how the entity responds to those business risks and ensures that those responses have been adequately implemented. Based on this information, the auditor assesses the level of risk of material misstatement of financial statement accounts. The risk of material misstatement is used to plan the auditing procedures to be performed. Chapter 4 provides a detailed discussion of the auditor's risk assessment process.

Establish Materiality

As discussed in Chapter 1, it is too costly for auditors to audit all transactions that occur within the entity. Thus, auditors consider materiality from a reasonable user perspective and communicate to users that 'the financial statements present fairly *in all material respects*'. The consideration of materiality is a matter of professional judgement and will vary across entities. During the planning of the audit, the auditor establishes a level of **overall materiality** for evaluating the financial statements as a whole. The auditor also establishes **performance materiality** – the amount of overall materiality used to plan and perform audit procedures at the account or disclosure level.[ii]

The last section in this chapter provides a comprehensive discussion of the process followed by the auditor in establishing materiality for the overall financial statements and performance materiality for significant accounts or disclosure.

Consider Multi-Locations or Business Units

Many entities have operations in multiple locations or operate many business units. As part of the planning process, the auditor determines 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. The auditor then assesses the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlates the amount of audit attention devoted to the location or business unit with the level of risk present. In auditing a company with operations in multiple locations or business units, the auditor needs to determine the extent to which audit procedures should be performed at selected locations or business units. ISA 600 on audit of group financial statements offers guidance on auditing an entity with multi-locations and business units.

Assess the Need for Experts

A major consideration in planning the audit is the need for experts (specialists). Auditing standards define an **auditor's expert** 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. Examples include experts in finance, tax, valuation, pension and information technology (IT). Such experts may assist the auditor with valuing financial instruments, determining physical quantities, valuing environmental liabilities or interpreting regulations or contracts. The use of an IT expert is a significant aspect of many audit engagements. When deciding whether an IT expert is to be used, a primary concern is the extent to which IT is used in processing accounting information. The presence of complex information technology may require the use of an IT expert. Chapter 6 covers these IT issues in more detail.

The auditor is still ultimately responsible for work performed by the expert. In relying on the expert, the auditor should evaluate the competence and objectivity of the expert, audit the inputs used by the expert (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 expert work for reasonableness, including the reasonableness of assumptions.

Consider Non-Compliance with Laws and Regulations

Auditing standards refer to **non-compliance** as acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. In other words, non-compliance means acts of violations of laws or regulations, sometimes also referred to as illegal acts. In some instances, fraud may consist of non-compliance with laws or regulations (see Chapter 4).

Auditing standards distinguish between provisions of laws and regulations that have a *direct* effect on the determination of *material* amounts and disclosures in the financial statements and those that have an *indirect* effect. For example, tax laws, pension laws and regulations that may affect the amount of revenue recognized under a government contract fall into the direct effect category. The auditor's responsibility for detecting non-compliance with laws and regulations recognized as having a direct and material effect on the financial statements is the same as that for error or fraud.

Other non-compliance, such as violations of laws and regulations of securities, environmental protection, equal employment and fair competition may only *indirectly* affect material amounts in the financial statements. For non-compliance with such laws and regulations, the auditor's responsibility is limited to performing specified audit procedures (such as inquiring of management whether the entity is in compliance with such laws and regulations) to help identify instances of non-compliance that may have a material effect on the financial statements. In addition, the auditor should during the

audit be aware that non-compliance may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of non-compliance with material but indirect effect on financial statements, the auditor should apply audit procedures specifically directed at determining whether such non-compliance has occurred. Thus, the auditor cannot be expected to detect non-compliance with all laws and regulations. Ordinarily, the further removed the non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it.

Stop and Think: Suppose your client was involved in mining coal. What laws or regulations might be applicable? Certainly, environmental regulations would apply.

Table 3–3 presents some examples of specific information or circumstances that indicate the possibility of non-compliance with laws and regulations. For example, the business world has seen a number of instances where payments of sales commissions or agent's fees were really bribes to secure contracts. When the auditor becomes aware of such a possible illegal act, he or she should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate its effects on the financial statements. The auditor should then discuss the matter with the appropriate level of management. If management does not provide satisfactory information, the auditor should consult with the entity's legal counsel and apply additional audit procedures, if necessary.

Table 3–3 Information or Circumstances that May Indicate Non-Compliance

- Unauthorized transactions or improperly recorded transactions.
- Investigations by regulatory and government bodies, or payment of unusual fines or penalties.
- Payments for unspecified services to consultants, related parties or employees.
- Unexplained payments to government officials.
- Sales commissions or agents' fees that appear excessive.
- Large payments in cash or unusual transfers to bank accounts.
- Unusual transactions with companies registered in tax havens.
- Failure to file tax returns or pay government duties.
- Adverse media comment.

If a non-compliance with laws and regulations has occurred or is likely to have occurred, the auditor should consider its implications for other aspects of the audit, particularly the reliability of management representations. The auditor should ensure that those charged with governance are adequately informed about the non-compliance. The auditor should also recognize that he or she may have a duty to notify parties outside the entity such as regulatory and enforcement authorities. For example, in many countries the auditor must report suspicion of money laundering to competent authorities.

Identify Related Parties[iii]

It is important for the auditor to evaluate the entity's identification of, accounting for and disclosure of transactions with *related parties*.[iv]

Auditors should attempt to identify all related parties during the planning phase of the audit. It is important to identify related party transactions because the transaction may not be 'at **arm's length**'.

For example, the entity may buy or sell goods or services at prices that differ significantly from prevailing market prices. The auditor should understand the entity's controls for identifying related parties, authorizing and approving related party transactions, and accounting for and disclosing related party transactions. The auditor also needs to inquire of management the names of related parties, the nature of the relationships, the types of transactions, and the reasons for entering into the transactions with the related parties.

Some other sources of information on related parties include:

- Minutes of those charged with governance.
- Conflict-of-interest statements from management and others.
- Financial and reporting information provided to creditors, investors and regulators.
- Contracts or other agreements (including side agreements that may not be formally documented between customers and vendors, and management).
- Contracts and other agreements representing significant unusual transactions.

Once related parties have been identified, audit personnel should be provided with their names so that transactions with such parties are identified and investigated.

Stop and Think: Think of additional examples of related party transactions and how the auditor might identify them. For example, a partnership composed of management may own a building leased by the entity. The auditor might detect such a related party transaction by examining the lease agreement.

Consider Additional Value-Added Services

As part of the planning process, the auditor should look for opportunities to recommend additional value-added services. Traditionally, value-added services have included tax planning, transaction support, IT consultancy and internal reporting processes. With auditors taking a more global view of the entity and its environment, there are opportunities to provide valuable services for the entity. For example, the auditor can provide recommendations based on the assessment of the entity's business risks. With the knowledge gathered through assessing business risks, the auditor can provide important feedback to management and those charged with governance on the strengths and weaknesses of business processes, strategic planning and emerging trends. Proper consideration of value-added services during the planning process should alert the audit engagement team of the need to proactively identify opportunities to improve client service. Of course, auditors are limited in the types of consulting services they can offer their audit clients (see Chapter 19).

Document the Overall Audit Strategy and Audit Plan

The auditor should document the overall audit strategy and audit plan. This involves documenting the decisions about the nature, timing and extent of audit tests. At this stage, the auditor compiles his or her knowledge about the entity's business objectives, strategies, and related business and audit risks. The auditor records how the entity is managing its risks (i.e. through internal control processes) and then documents the effect of the risks and controls on the planned audit procedures. Auditors ensure they have addressed the risks they identified in their understanding of the risk assessment process by documenting the linkage from the entity's business objectives and strategy to audit plans. The form of documentation varies from firm to firm, but a simple illustration using EarthWear might look as follows:

Business Objectives and Strategy	Business Risks	Account(s)/ (Assertions)	Audit Risks	Controls	Effect on Audit Plan
Increase market share through sales at new locations (e.g. during the current year websites were developed for ten more countries)	Restrictive trade laws may affect sales tactics Strong consumer protection in several European countries.	*Revenue:* accuracy and valuation	Overstated due to pricing issues	EwC has installed a special group to track compliance with local and international laws	Observe and test group's policies and procedures (see work paper R-11)
	Political uncertainly in less developed countries (LDCs)	*Reserve for returns:* completeness	Understated due to failure to properly track returns in new locations	EwC has initiated more frequent review of returns in new locations	Extend audit work on EwC's return tracking with emphasis on new locations (see work paper R-15)
	Currency risks	*Gains/losses from currency hedging:* valuation and accuracy	Gains/ losses not properly calculated or accrued on hedging activity	EwC has strong controls in the treasury department to account for hedging activities	Increase the number of hedging contracts tested, with particular emphasis on contracts in unstable currencies (see work paper S-14)

The overall audit strategy and audit plan are documented in a written plan. The audit plan contains specific audit procedures. Exhibit 3–2 presents a partial audit plan for substantive tests of accounts receivable. The types of audit tests are discussed in the next section.

Supervision of the Audit

LO8

An important part of the planning and conduct of the audit is appropriate supervision of audit personnel. 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. The engagement partner should:

- 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.
  - Matters that could affect the procedures to be performed or the evaluation of the results of those procedures.

Exhibit 3–2 A Partial Audit Plan for Substantive Procedures Testing of Accounts Receivable

Audit Procedures	W/P Ref.	Completed by	Date
1 Obtain the 31 December 2013, aged accounts receivable trial balance and	_____	_____	_____
a Foot the trial balance and agree total to accounts receivable control account.	_____	_____	_____
b Randomly select 30 accounts from the aged trial balance; agree the information per the aged trial balance to the original sales invoice and determine if the invoice was included in the appropriate ageing category.	_____	_____	_____
2 Confirm a sample of accounts receivable	_____	_____	_____
a For all responses with exceptions, follow up on the cause of the error.	_____	_____	_____
b For all non-responses, examine subsequent cash receipts and or supporting documents.	_____	_____	_____
c Summarize the sampling test results.	_____	_____	_____
d Summarize the confirmation results.	_____	_____	_____
3 Test sales cut-off by identifying the last shipping advice for the year and examining five large sales for three days before and after year end.	_____	_____	_____
4 Test the reasonableness of the allowance for doubtful accounts by the following:	_____	_____	_____
a Test the reasonableness using past percentages on bad debts.	_____	_____	_____
b For any large account in the aged trial balance greater than 90 days old, test for subsequent cash receipts.	_____	_____	_____
5 Prepare a memo summarizing the tests, results and conclusions.	_____	_____	_____

- Direct engagement team members to bring any significant accounting and auditing issues they identify to the attention of the engagement partner 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.
  - The results of the work support the conclusions reached.

Proper supervision should help ensure that the audit is conducted in accordance with auditing standards.

Types of Audit Tests

LO9 There are three general types of audit tests:

1 Risk assessment procedures.
2 Tests of controls.
3 Substantive procedures.

Risk Assessment Procedures

Auditor risk assessment procedures are used to obtain an understanding of the entity and its environment, including its internal control. **Risk assessment procedures** include inquiries of management and others, preliminary **analytical procedures**, and observation and inspection. Such procedures are used to assess the risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures are covered in depth in Chapter 4.

Tests of Controls

Tests of controls are audit procedures performed to test the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the relevant assertion level. The following audit procedures are examples of tests of controls:

- Inquiries of appropriate management, supervisory and staff personnel.
- Inspection of documents, reports and electronic files.
- Observation of the application of specific controls.
- Walk-throughs, 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.

For example, in evaluating the design of an IT application control and determining whether it has been implemented, the auditor may make inquiries of entity personnel and inspect relevant systems documentation, reports or other documents. Table 3–4 provides examples of controls that are normally present in the processing of revenue transactions and tests of controls that the auditor might use to test the operational effectiveness of the controls.

Table 3–4 Examples of Internal Controls and Tests of Controls

Internal Controls	Tests of Controls
Create a separation of duties between the shipping function and the order entry and billing functions.	Observe and evaluate whether shipping personnel have access to the order entry or billing activities.
Credit Department personnel initial sales orders, indicating credit approval.	Inspect a sample of sales orders for presence of initials of Credit Department personnel.
Billing Department personnel account for the numerical sequence of sales invoices.	Inquire of Billing Department personnel about missing sales invoice numbers.
Agree sales invoices to shipping document and customer order for product types, price and quantity.	Recompute the information on a sample of sales invoices.

Substantive Procedures

Substantive procedures are designed to detect material misstatements (that is, monetary errors) in a transaction class, account balance and disclosure element of the financial statements. There are two categories of substantive procedures: (1) tests of details; and (2) substantive analytical procedures.

Tests of details

Tests of details are usually categorized into two types: (1) **substantive tests of transactions** and (2) **tests of details of account balances and disclosures**. *Substantive tests of transactions* test for errors or fraud in individual transactions. For example, an auditor may examine a large purchase of inventory by testing that the cost of the goods included on the vendor's invoice for that purchase is properly recorded in the inventory and accounts payable accounts.

Tests of details of account balances and disclosures focus on the items that are contained in the ending financial statement account balances and disclosures. For example, the auditor may want to test accounts receivable. To test the details of the balance of accounts receivable, the auditor is likely to send confirmations to a sample of customers.

Substantive Analytical Procedures

The term *analytical procedure* means evaluations of financial information through analysis of plausible relationships (e.g. examination of trends and ratios) among both financial and non-financial data. Analytical procedures also encompass the investigation, if necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. Substantive analytical procedures are discussed in more detail in Chapter 5.

Dual-Purpose Tests

Tests of controls check the operating effectiveness of controls, while substantive tests of transactions are concerned with monetary misstatements. However, it often makes sense to design audit procedures to conduct both a test of controls and a substantive test of transactions simultaneously on the same document. For example, in Table 3–4, the last control procedure shown is agreement of sales invoices to shipping documents and customer orders for product type, price and quantity. The test of controls shown is to recompute the information on a sample of sales invoices. While this test primarily checks the effectiveness of the control, it also provides evidence on whether the sales invoice contains the wrong quantity, product type or price. **Dual-purpose tests** can also improve the efficiency of the audit.

This text discusses tests of controls within each business process. We discuss substantive tests of transactions along with other substantive tests pertaining to each business process. You should remember, however, that in most audit situations substantive tests of transactions are conducted at the same time as tests of controls.

Materiality[v]

LO10 An important part of audit planning is to determine materiality for the financial statements taken as a whole and to decide on performance materiality for significant accounts or disclosures. These determinations are an important aspect of developing an overall audit strategy and a detailed audit plan. As mentioned in Chapter 1, it is not cost-efficient to perform an audit that catches every misstatement no matter how small. Thus, the auditor designs the audit to provide reasonable assurance of detecting misstatements that are of sufficient magnitude to affect the judgement of reasonable financial statement users.

The auditor's consideration of materiality on an audit is a matter of *professional judgement*. Materiality is assessed in terms of the potential effect of a misstatement on decisions made by a reasonable user of the financial statements. IAASB follows such user perspective in considering what is material:

> *Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.* (ISA 320)

Auditing standards on materiality provide further guidance to auditors in assessing the effects of a misstatement on the economic decisions of users. Users are assumed to:

- Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information in the financial statements with reasonable diligence.
- Understand that financial statements are prepared and audited to levels of materiality.
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgement and the consideration of future events.
- Make reasonable economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions. Note that the opinion paragraph of the auditor's report states that the financial statements present fairly, 'in all material respects'. This phrase communicates to third parties that the audit report is limited to material information.

The following sections present an approach to assessing materiality that is based on the general approach provided by auditing standards and current audit practice.[vi] The approach presented here provides the reader with a basic framework for understanding the consideration of materiality in an audit.

Steps in Applying Materiality

LO11

Figure 3–2 presents the three major steps in the application of materiality to an audit. Steps 1 and 2 are normally performed early in the engagement as part of planning the audit (see Figure 1–3 in Chapter 1). Step 3 is performed usually prior to, or when the auditor evaluates the evidence at the completion of the audit to determine if it supports the fair presentation of the financial statements (again, refer to Figure 1–3).

Step 1: Determine Overall Materiality

Auditing standards require the auditor to establish a materiality amount for the financial statements as a whole. They do not provide specific guidance on how to determine overall materiality, but refer to examples of benchmarks such as profit before tax and total revenue that may be appropriate for determining materiality, depending on the circumstances of the entity.

Overall materiality is the maximum amount by which the auditor believes the financial statements could be misstated and still not affect the decisions of users. Materiality, however, is a relative, not an absolute, concept. For example, €5,000 might be considered highly material for a small sole proprietorship, but this amount would clearly be immaterial for a large multinational company. Thus, the relative size of the company being audited affects overall materiality.

Table 3–5 provides examples of benchmarks and relevant percentages to apply to those benchmarks based on current practice.

Figure 3–2 Steps in Applying Materiality on an Audit

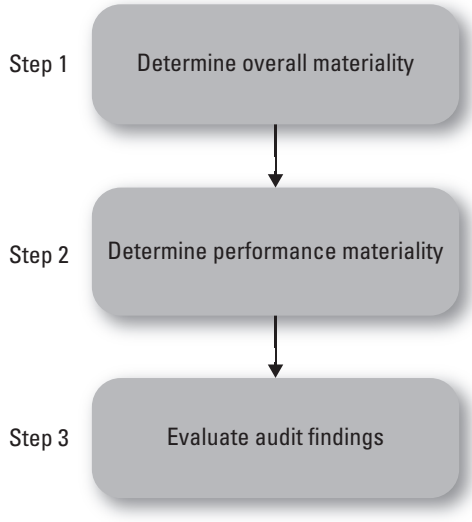


Table 3–5 Common Quantitative Benchmarks and Relevant Percentages Used for Establishing Overall Materiality

Benchmark	Relevant Percentages
Profit (loss) before tax	3–10
Total assets	0.25–2
Total revenues	0.5–5
Net assets	3–5
Total equity	1–5

For public companies, firms typically use 2–5 per cent of profit (income) before tax. For non-public companies, profit before tax is also used for profit-oriented entities with stable earnings, but other benchmarks might be appropriate. A common rule of thumb in practice is to use 5 per cent of profit before tax. However, if current year pretax profit is not stable, auditors might use 'normalized earnings' – an average of the previous three years' pretax profit, or another benchmark (e.g. total assets or total revenues).

Difficulties also arise in using profit as a benchmark when the entity is close to breaking even or experiencing a loss. For example, suppose that an entity has profit before tax of €3,000,000 one year and the auditor decides that 5 per cent of that amount, €150,000, would be material. The scope of the audit in that year would be based on an overall materiality of €150,000. Suppose, in the following year, the entity's profit before tax falls to €250,000 due to a temporary decrease in sales prices for its products. If the auditor uses the 5 per cent factor, the overall materiality would be €12,500 (€250,000 × 0.05), and a much more extensive audit would be required. Thus, with fluctuating profit, using an average of the prior three years' profit or another base such as total assets or total revenues may provide a more stable benchmark from year to year.

For not-for-profit entities, total revenues or total expenses might be more appropriate benchmarks. Lastly, for asset-based entities (e.g. investment funds), the auditor might use net assets as a benchmark.

In deciding the appropriate percentage to apply to a selected benchmark, the auditor would choose a lower percentage within the range for qualitative factors such as:

- Materiality misstatements in prior years.
- High risk of fraud.
- The entity close to violating a covenant in a loan agreement.
- Small amounts may cause the entity to miss forecasted revenues or earnings, or affect the trend in earnings.
- The entity operates in a volatile business environment, has complex operations (multi-locations) or operates in a highly regulated industry.

Step 2: Determine Performance Materiality[vii]

The auditor should determine performance materiality at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. The purpose of setting performance materiality is to establish a scope for the audit procedures for the individual account balance or disclosure.

In practice, auditors commonly set performance materiality for each account at between 50 and 75 per cent of overall materiality. The firms also provide guidance to assist their auditors in determining the appropriate percentage to use within the range. In addition to the factors mentioned above for setting the percentage for overall materiality, firm guidance includes the following factors that would cause the auditor to use a lower percentage for performance materiality:

- High risk of misstatement within the account balance, class of transaction or disclosure.
- Increased number of accounting issues that require significant judgement and/or more estimates with high estimation uncertainty.

- A history of significant deficiencies and/or a high number of deficiencies in internal control.
- High turnover of senior management or key financial reporting personnel.

Obviously, using 50 to 75 per cent of overall materiality results in total combined performance materiality that is greater than overall materiality. Some firms cap the size of combined or aggregated performance materiality to a multiple of overall materiality. For example, combined performance materiality for each account can be up to a multiple of four times overall materiality.

There are a number of reasons why total combined performance materiality greater than overall materiality makes sense from an audit planning perspective:

- Not all accounts will be misstated by the full amount of their performance materiality.
- Audits of the individual accounts are conducted simultaneously (typically by different members of the audit team). If accounts were audited sequentially, unadjusted misstatements observed during testing would count against materiality and theoretically the auditor could carry the unused portion of materiality to the next account and so forth.
- Materiality as a percentage of large accounts, such as inventory; accounts receivable; revenues; or plant, property and equipment, is often a very small fraction of the account (less than 2 per cent), and the scope of planned auditor procedures will be sufficiently precise to identify significant misstatements.
- When errors are identified, the auditors typically perform additional procedures in that, and related, accounts.
- Overall financial statement materiality serves as a 'safety net'. If individual unadjusted misstatements are less than performance materiality, but aggregate to an amount greater than materiality, then (1) the audit client will need to make adjustments to decrease the unadjusted misstatements below materiality; (2) the auditor will need to perform more testing; and/or (3) the auditor will issue a qualified or adverse opinion.

Taken together, these points suggest that it would be inefficient for the auditor to simply subdivide materiality proportionally to each account. This would result in unnecessarily low performance materiality levels. The lower the performance materiality, the more extensive the required audit testing. In the extreme, if performance materiality were very small or zero, the auditor would have to test every transaction making up an account. Imagine how a building surveyor's investigation and related costs would differ if she or he were asked to identify all potential problems greater than €2 versus a 'tolerable damage' threshold of €2,000. Similarly, auditing standards recognize that an auditor works within economic limits, and for the audit opinion to be economically useful it must be completed in a reasonable length of time at reasonable cost.

Step 3: Evaluate Audit Findings

Step 3 is completed near the end of the audit, when the auditor evaluates all the evidence that has been gathered. Based on the results of the audit procedures conducted, the auditor aggregates misstatements from each account or disclosure. In evaluating misstatements relating to accounting estimates, the auditor should be very careful in considering the risk of material misstatement in accounts that are subject to estimation. Examples of such estimates include inventory obsolescence, loan loss reserves, uncollectible receivables and warranty obligations. Seldom can accounting estimates be considered accurate with certainty. If, based on the best audit evidence, the auditor believes the estimated amount included in the financial statements is unreasonable, the difference between that estimate and the closest reasonable estimate should be treated as a misstatement. The closest reasonable estimate may be a range of acceptable amounts or a precisely determined point estimate, if that is a better estimate than any other amount. For example, suppose that the auditor concludes based on the evidence that the allowance for doubtful accounts should be between €210,000 and €270,000. If management's recorded estimate falls within this range (say, €250,000), the auditor may conclude that the recorded amount is reasonable and no difference would be aggregated. If the recorded estimate falls outside this

range (say, €190,000), the difference between the recorded amount and the amount at the closest end of the auditor's range (€20,000) would be aggregated as a judgemental misstatement.

In evaluating the aggregate misstatement, the auditor should consider the effect of misstatements not adjusted in the prior period because they were judged to be immaterial. The auditor compares this aggregate misstatement to the overall materiality.

If the auditor's judgement about materiality at the planning stage (Step 1) was based on the same information available at the evaluation stage (Step 3), materiality for both planning and evaluation purposes would be the same. However, the auditor may identify factors or items during the course of the audit that cause a revision to the overall materiality. Thus, the overall materiality used to plan the audit may differ from the materiality used in evaluating the audit findings. When this occurs, the auditor should carefully document the reasons for using a different materiality level.

When the aggregated misstatements are less than the overall materiality, the auditor can conclude that the financial statements are fairly presented. Conversely, when the aggregated misstatements are greater than overall materiality, the auditor should request that the entity adjust the financial statements. If the entity refuses to adjust the financial statements for material misstatements, the auditor should issue a qualified or adverse opinion because the financial statements do not present fairly in accordance with the applicable financial reporting framework.

An Example

LO12 In this example, the three steps for applying materiality are discussed using financial information for EarthWear Clothiers for the year ended 31 December 2013. This financial information is taken from the case illustration included in Chapter 1.

Step 1: Determine the Overall Materiality

EarthWear Clothiers' profit before tax is €36 million (rounded). Assume that the auditors, Willis & Adams International, have decided that 5 per cent of this benchmark is appropriate for overall materiality. Thus, they determine overall materiality to be €1,800,000 (€36,000,000 × 0.05). To determine the final amount for materiality, the auditors should consider whether any qualitative factors (i.e. close to violating a covenant in a loan agreement) are relevant for the engagement. In our example, assume that the auditors have determined that no qualitative factors are relevant and that the €1,800,000 will be used for overall materiality. This is the amount that is used for determining performance materiality for specific accounts or disclosures in Step 2.

Step 2: Determine Performance Materiality

We assume that EarthWear's auditors determine performance materiality by using 50 per cent of overall materiality. Therefore, performance materiality is €900,000 (€1,800,000 × 0.05).

Step 3: Evaluate Audit Findings

Performance materiality can be used for determining the fair presentation of the individual accounts after completion of the audit work. Assume that during the course of the audit the auditor identified four misstatements. The misstatements are compared to the performance materiality for each account. For example, the first misstatement indicates a factual misstatement in the accrual of payroll expense and bonuses. The total misstatement of accrued payroll is €215,000. The second entry is based on the results of a statistical sampling application for inventory. The statistical results indicated there is a misstatement of €312,500. In this example, no error is larger than the performance materiality amount of €900,000, and the total of the misstatements is also less than overall materiality. Before making a final decision, the auditor should consider the possibility of undetected misstatements, further possible misstatements that may be due to sampling and misstatements that carry forward from the prior year. The auditor should document his or her conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated (see Exhibit 3–3). If one of the entries were in excess of the performance materiality for an account balance, or if the aggregated misstatements were greater than overall materiality, the entity would have to adjust the financial statements or the auditor would have to issue a qualified or adverse opinion.

Exhibit 3–3 Example Working Paper for Evaluating Detected Misstatements

EARTHWEAR CLOTHIERS
Schedule of Proposed Adjusting Entries 31/12/13

Working Paper Ref.	Proposed Adjusting Entry	Assets	Liabilities	Equity	Revenues	Expenses
N10	Payroll expense					75,000
	Bonuses					140,000
	Provisions		215,000			
	To accrue payroll through 31/12 and recognize 2013 bonuses					
F20	Cost of sales					312,500
	Inventory	(312,500)				
	To adjust ending inventory based on sample results					
F22	Inventory	227,450				
	Accounts payable		227,450			
	To record inventory in transit at 31/12					
R15	Accounts receivable	79,850				
	Sales				79,850	
	To record sales cut-off errors at 31/12					
	Total	€ (5,200)	€442,450		€79,850	€527,500

Performance materiality = €900,000 (50 per cent of overall materiality).
Conclusion: Based on the above analysis, the account balances for EarthWear Clothiers are fairly stated in accordance with IFRSs.

Key Terms

Analytical procedures. Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

Arm's length transaction. A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Audit committee. A committee ordinarily consisting of members of the board of directors, charged with overseeing the entity's system of internal control, internal and external auditors, and the financial reporting process. Members typically must be independent of management and the company.

Audit plan. Converts the overall audit strategy into a more detailed plan, and includes the nature, timing and extent of audit procedures to be performed.

Audit procedures. Specific acts performed as the auditor gathers evidence to determine if specific audit assertions are being met.

Auditor's expert. 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.

Dual-purpose tests. Tests of transactions that both evaluate the effectiveness of controls and detect monetary errors.

Engagement letter. A letter that formalizes the contract between the auditor and the entity, and outlines the responsibilities of both parties.

Engagement partner. The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Internal audit function. An appraisal activity established or provided as a service to the entity. Its functions include, among other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.

Internal auditors. Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

Materiality. Misstatements, including omissions, that individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.

Non-compliance. Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Overall audit strategy. The auditor's plan for the expected conduct, organization and staffing of the audit. Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Overall materiality. The maximum amount by which the auditor believes the financial statements could be misstated and still not affect the decisions of users.

Performance materiality. The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of **uncorrected misstatements** and undetected misstatements exceeds materiality for the financial statements as a whole.

Planning. Involves establishing the overall audit strategy for the engagement and developing an audit plan.

Risk assessment procedures. The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control.

Substantive procedures. Audit procedures performed to detect material misstatements at the assertion level, and including substantive analytical procedures and tests of details of classes of transactions, account balances and disclosures.

Substantive tests of transactions. Tests to detect errors or fraud in individual transactions.

Tests of controls. Audit procedures performed to obtain audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Tests of details of account balances and disclosures. Substantive tests that concentrate on the details of items contained in the account balance and disclosure.

Those charged with governance. Those persons or person with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the financial reporting process.

Uncorrected misstatements. Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Review Questions

3–1 (LO1) What types of inquiries about a prospective client should an auditor make to third parties?

3–2 (LO1) What type of information should be requested by the successor auditor from the predecessor auditor?

3–3 (LO3,4) What is the purpose of an engagement letter? List the important information that the engagement letter should contain.

3–4 (LO5) What factors should an external auditor use to assess the competence and objectivity of the internal audit function?

3–5 (LO6) Who are those charged with governance, and what are their responsibilities?

3–6 (LO7) List the matters an auditor should consider when developing an audit plan.

3–7 (LO7) List five circumstances that may indicate that non-compliance with laws or regulations (illegal acts) may have occurred.

3–8 (LO7) What are some of the sources of information that may be used to identify transactions with related parties?

3–9 (LO8) What actions should the engagement team members be informed of by the engagement partner as part of his or her supervisory role?

3–10 (LO9) What are the three general types of audit tests? Define each type of audit test and give two examples of each.

3–11 (LO10,11) Why is it important for audit firms to develop policies and procedures for establishing materiality?

3–12 (LO11) List and describe the three major steps in applying materiality to an audit.

3–13 (LO11) While profit before tax is frequently used for calculating overall materiality, discuss circumstances when total assets or revenues might be better bases for calculating overall materiality.

3–14 (LO11) Give three examples of qualitative factors that might affect the overall materiality.

3–15 (LO11) Why do auditors determine and apply performance materiality?

Problems

3–16 (LO1,4) The audit committee of the board of directors of Unicorn Corporation asked Tish & Field, independent auditors, to audit Unicorn's financial statements for the year ended 31 December 2013. Tish & Field explained the need to make an inquiry of the predecessor auditor and requested permission to do so. Unicorn's management agreed and authorized the predecessor auditor to respond fully to Tish & Field's inquiries.

Required:

a What information should Tish & Field obtain during its inquiry of the predecessor auditor prior to accepting the engagement?

b What other audit procedures should Tish & Field perform in evaluating Unicorn as a potential client?

c After a satisfactory communication with the predecessor auditor, Tish & Field drafted an engagement letter that was mailed to the audit committee of the board of directors of

Unicorn Corporation. The engagement letter clearly set forth the arrangements concerning the involvement of the predecessor auditor and other matters. What other matters would Tish & Field generally have included in the engagement letter?

(Adapted from AICPA)

3–17 (LO2,3,7) Parker is the in-charge auditor for the upcoming annual audit of FGH Company, a continuing audit client. Parker will supervise two assistants on the engagement and will visit the entity before the fieldwork begins.

Parker has completed the engagement letter and established an understanding with the Chief Internal Auditor on the assistance to be provided by the internal audit function.

Required:

List the preliminary engagement and planning activities that Parker needs to complete.

(Adapted from AICPA)

3–18 (LO3,4) An independent auditor has been asked to audit the financial statements of a company for the first time. All preliminary verbal discussions and inquiries among the auditors, the company, the predecessor auditor and all other necessary parties have been completed. The auditor is now preparing an engagement letter.

Required:

a *List the items that should be included in the typical engagement letter in these circumstances.*
b *Describe the benefits derived from preparing an engagement letter.*

(Adapted from AICPA)

3–19 (LO9) Exhibit 3–2 contains a partial audit plan for substantive tests of accounts receivable.

Required:

For audit procedures 1–4, identify the primary assertion being tested.

3–20 (LO11,12) For each of the following scenarios, perform the three steps in the materiality process: (1) determine overall materiality, (2) determine performance materiality, and (3) evaluate the audit findings. Justify your decisions.

Scenario 1:

Murphy & Johnson is a manufacturer of small motors for lawnmowers, tractors and snowmobiles. The components of its financial statements are: (1) profit before tax = €21 million, (2) total assets = €550 million, and (3) total revenues = €775 million.

During the course of the audit, Murphy & Johnson's audit firm detected two misstatements that aggregated to an overstatement of profit before tax of €1.25 million.

Scenario 2:

Delta Investments provides a group of mutual funds for investors. The elements of its financial statements are: (1) profit before tax = €40 million, (2) total assets = €4.3 billion, and (3) total revenues = €900 million.

During the course of the audit, Delta's audit firm detected two misstatements that aggregated to an overstatement of profit before tax of €5.75 million.

Scenario 3:

Swell Computers manufactures desktop and laptop computers. The elements of the financial statements are: (1) profit before tax = €500,000, (2) total assets = €2.2 billion, and (3) total revenues = €7 billion.

During the course of the audit, Swell's audit firm detected one misstatement that resulted in an overstatement of profit before tax of €1.5 million.

3–21 (LO11,12) You are the audit manager for Ken-Ron Enterprises. Your firm has been the entity's auditor for 15 years. Your firm normally uses a range of 3 to 5 per cent of profit before tax to calculate overall materiality and 50 to 75 per cent of overall materiality to calculate performance materiality. Ken-Ron has reported the following financial statement data (in millions) for the last four years:

	2013	2012	2011	2010
Profit before tax	105*	584	520	453
Total assets	23,422	16,137	13,239	11,966
Total revenues	20.272	13,289	9,189	8,984

* Note that the significant decline in profit before tax in 2013 is due to a large nonrecurring charge.

Required:

a *If you planned on using profit before tax as the benchmark to compute overall materiality and performance materiality, how would you compute those amounts for 2013? Prepare and justify your calculations.*

b *Determine overall materiality and performance materiality using either total assets or total revenues as the benchmark. Make the calculations by utilizing both 0.25 per cent and 2 per cent, the endpoints of the range that your firm guidance provides.*

c *Assume that during the course of the 2013 audit you discovered misstatements totalling €50 million (approximately 50 per cent of the 2013 profit before tax of €105 million). Discuss whether this amount of misstatement is material given your benchmark calculations from parts a and b above.*

Discussion Case

3–22 (LO7,9) Forestcrest Woollen Mills is a closely held company that has existed since 1920. The company manufactures high-quality woollen cloth for men's and women's outerwear. Your firm has audited Forestcrest for 15 years.

Five years ago, Forestcrest signed a consent decree with the Environmental Protection Agency. The company had been convicted of dumping pollutants (such as bleaching and dyeing chemicals) into the local river. The consent decree provided that Forestcrest construct a water treatment facility within eight years.

You are conducting the current year audit, and you notice that there has been virtually no activity in the water treatment facility construction account. Your discussion with the controller produces the following comment: 'Because of increased competition and lower sales volume, our cash flow has decreased below normal levels. You had better talk to the president about the treatment facility.'

The president (and majority shareholder) tells you the following: 'Given the current cash flow levels, we had two choices: lay off people or stop work on the facility. This is a rural area with few other job opportunities for our people. I decided to stop work on the water treatment facility. I don't think that the state will fine us or close us down.' When you ask the president if the company will be able to comply with the consent decree, he informs you that he is uncertain.

Required:

a *Discuss the implications of this situation for the audit and audit report.*

b *Would your answer change if these events occurred in the seventh year after the signing of the consent decree?*

Internet Assignments

3–23 (LO5) Visit the Institute of Internal Auditors (IIA) homepage (www.theiia.org) and familiarize yourself with the information contained there. Search the site for information about the IIA's requirements for the objectivity and independence of internal auditors.

3–24 (LO7) EarthWear Clothiers makes high-quality clothing for outdoor sports. It sells most of its products through mail order. Use the Internet to obtain information about the retail mail-order industry.

Hands-On Cases

Visit *www.mcgraw-hill.co.uk/textbooks/eilifsen* to find detailed descriptions of the following chapter-specific cases and to download required materials.

EarthWear Case 3-1 Client Acceptance
Using Willis and Adam International's client acceptance/continuance forms, evaluate the continuance decision for EarthWear as an audit client.

EarthWear Case 3-2 Planning Memo
Using information from the text as well as from additional EarthWear Clothiers' and Willis & Adam International's documents, prepare an audit planning memo.

EarthWear Case 3-3 Materiality and Performance Materiality
Using Willis and Adam International's guidelines and EarthWear's unaudited financial statements, determine overall materiality and performance materiality.

Notes

i The legal and regulatory responsibilities and requirements for communication between the successor and predecessor auditor may differ among jurisdictions. For example, the successor auditor may have a legal duty to question the predecessor auditor on certain matters about the engagement and the predecessor auditor may have a legal duty to respond.

ii Overall materiality is sometimes referred to as planning materiality. The US Public Company Accounting Oversight Board's (PCAOB) standards refer to performance materiality as tolerable misstatement.

iii E. A. Gordon, E. Henry, T. J. Louwers and B. J. Reed, 'Auditing Related Party Transactions: A Literature Overview and Research Synthesis', *Accounting Horizons* (March 2007), pp. 81–102, for a review on research on related parties.

iv See International Accounting Standard (IAS) 24 *Related Party Disclosures* for a detailed definition of related parties.

v See W. F. Messier, Jr., N. Martinov and A. Eilifsen, 'A Review and Integration of Empirical Research on Materiality: Two Decades Later', *Auditing: A Journal of Practice & Theory* (November 2005), pp. 153–187, for a discussion of materiality research.

vi The discussion in this section is based on A. Eilifsen and W. F. Messier, Jr., 'Materiality Guidance of the Major Auditing Firms', Working Paper, Norwegian School of Economics and University of Nevada, Las Vegas. This paper reviews the existing materiality standards and provides a detailed summary of the materiality practices of the major auditing firms for profit-oriented entities.

vii The term 'performance materiality' is now used in the international materiality standards. Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. Thus, performance materiality is a concept similar to tolerable misstatement.

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