# Chapter 5 Instructor’s Manual
## Audit Planning and Types of Audit Tests

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The major focus of Chapter 5 is audit planning. It is critical to impress upon the students how good audit planning leads to an efficient and effective audit. The discussion covers the following phases of the audit that relate to audit planning (refer to Figure 5-1):

- Client acceptance and continuance.
- Establishing an understanding with the client.
- Preliminary engagement activities.
- Planning the audit.

Use Figure 5-1

The chapter also covers the types of audit tests and provides coverage of analytical procedures. *The Advanced Module 1* presents ratios that are used for financial statement analysis. *The Advanced Module 2* discusses special considerations in the audit of group financial statements.

**[LO1] Client Acceptance and Continuance**

It is important for the students to have an understanding of the client acceptance and continuance process. We first talk about the issues the auditor should consider when going through the client acceptance and continuance process. Table 5-1 provides a list of procedures that the auditor can use to evaluate a prospective client. The key factor to emphasize with the students is the fact that the client acceptance and continuance process is a valuable source of information for identifying business risks.

Use Table 5-1

**[LO2] Establishing an Understanding with the Client**

Three major topics should be discussed: the engagement letter; the internal auditors; and those charged with governance.

**[LO3] The Engagement Letter**

The students should be told about the importance of the engagement letter. We emphasize to the students that the engagement letter is the contract between the auditor and the client. It spells out each party’s responsibilities. We then have the students look at the engagement letter included in Exhibit 5-1 and then discuss the information contained in the letter.

Use Exhibit 5-1

**[LO4] Internal Auditors**

This is a good time to discuss the importance of the internal auditors to the financial statement audit. We focus on the factors included in Table 5-2 for assessing the competence and objectivity of internal auditors.

Table 5-2
[LO5] Those Charged with Governance
We usually start by referring to the discussion of corporate governance in Chapter 2. We spend a bit of time discussing the relevant structure of corporate governance. (The structure of corporate governance may vary from country to country.) We then introduce the definition of those charged with governance. We also discuss the relationship between those charged with governance (e.g. the board of directors, the supervisory board, and the audit committee) and the external auditor. It is important to stress that the auditor should establish a constructive working relationship with those charged with governance in the entity. It is also important to focus on how an active board of directors (supervisory board or audit committee) improves the auditor's independence. There are numerous sources of additional information about corporate governance, including audit committees. You might consider inviting an audit committee member to speak with your class about his/her changing role in corporate governance.

[LO6] Preliminary Engagement Activities
There are two preliminary engagement activities: (1) determining the audit engagement team requirements; and (2) ensuring that the audit engagement team and audit firm are in compliance with ethical requirements, including independence.

Audit firms must insure that their audits are staffed by individuals possessing an appropriate amount of technical training for the client. Factors that should be considered when staffing an engagement include:

- The client’s size and complexity.
- Level of risk.
- Industry or other expertise.
- Personnel availability.
- Timing of the work to be performed.

The second issue that must be addressed as part of preliminary planning is independence of the audit engagement team and firm. We would stress that professional standards require (1) the firm to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with the relevant ethical requirements and that independence is maintained; and (2) the engagement partner to ensure that all individuals assigned to the engagement are independent of the client. Point out that independence requirements will be covered later.

[LO7] Planning the Audit
This section presents the steps that are involved in engagement planning, including:

- Assessing business risks and establishing materiality.
- Assessing the need for experts.
- Considering the possibility of non-compliance with laws and regulations (illegal acts).
- Identifying related parties.
- Conducting preliminary analytical procedures.
• Considering additional value-added services.

While we spend time on each step, we mainly focus on:

• Assessing the need for experts.
  • Considering the possibility of non-compliance with laws and regulations (illegal acts).
  • Identifying related parties.
  • Conducting preliminary analytical procedures.

Use Table 5-3 to discuss issues related to non-compliance with laws and regulations.

Use Table 5-3

[LO8] Types of Audit Tests
Present the three general types of audit tests:

• Risk assessment procedures.
• Tests of controls.
• Substantive procedures (tests of details of classes of transactions, account balances, and disclosures; and substantive analytical procedures).

Define each type of test and give examples. We find that most students have difficulty distinguishing between tests of controls and substantive procedures. We tell the students that while textbooks make such distinctions, in the real world, most of these tests serve both purposes (i.e. they are dual-purpose tests). We usually cover Problem 5-20 here.

[LO9] Substantive Analytical Procedures
Given the growing importance of analytical procedures, we spend considerable time with this topic. In particular, we focus on:

• The definition of analytical procedures.
• The purposes of analytical procedures.
• The decision process.

We spend considerable time discussing the decision process after we go over the definition and purposes of analytical procedures. We introduce the three types of procedures: trend analysis, ratio analysis and reasonableness analysis (using Table 5-5). We go over Figure 5-2 which provides an overview of the auditor's decision process for substantive analytical procedures to collect audit evidence. We focus on the first step: developing an expectation for the amount or account balance. We make sure the students understand the idea of the quality or precision of an expectation and the four factors that affect it. It is important to ‘walk’ the students through this figure, focusing on the important steps in the process. The text uses EarthWear Clothiers to illustrate the process which we cover as well in class. We also use the Advanced Module 1 to show the students the different types of ratios that can be used as analytical procedures. This is a good time to assign Problem 5-22 on estimating EarthWear’s ‘reserve for returns.’
Use Table 5-5 and Figure 5-2

[LO10] The Audit Testing Hierarchy
We begin the topic by asking the students (and listing on the board) what decisions they believe are involved for testing significant balances. We try to get something up on the board similar to Figure 5-4. We then talk about why the hierarchy is important: it is more effective and more efficient. We make sure to point out that assurance cannot be obtained solely from testing controls; an auditor must also perform some type of substantive procedure (it may be analytical procedures or tests of details or both). Sometimes it is difficult for students to understand and visualize how the auditor decides on the proper evidence mix. We use Figures 5-5 and 5-6 (the assurance buckets) to aid their understanding. We do point out that ultimately it is the professional judgment of the auditor that will decide.

Use Figures 5-4, 5-5 and 5-6

We review the following financial ratios used by auditors as analytical procedures:

- Short-term liquidity ratios
  - Current ratio
  - Quick ratio
  - Operating cash flow ratio
- Activity ratios
  - Receivables turnover and days outstanding
  - Inventory turnover and days of inventory on hand
- Profitability ratios
  - Gross profit percentage
  - Profit margin
  - Return on assets
  - Return on equity
- Coverage ratios
  - Debt to equity
  - Times interest earned

We remind students that auditors may compare the client’s ratios with industry averages, but we stress that because industry ratios are averages that they may not capture operating or geographical factors that may be specific to the client. Also we discuss the use of ratios in trend analysis to observe changes in the health of the company over time.
Advanced Module 2: Special Considerations in the Audit of Group Financial Statements

We start with the definition of a component in a group and a component auditor. We then explain that the work performed by the group engagement team on a component is determined by the significance of the component and the involvement of component auditors. Figure 5–7 outlines how the significance of the component affects the work to be performed on the financial information of the component. We conclude by explaining how the group engagement team should be involved when component auditors perform work on its behalf on the financial information of the components.

Use Figure 5-7

Discussion Cases
Discussion Case 5-24 is based on a real world situation. It is a good case for discussing a potential non-compliance act and its possible effects on the audit. In this case, the company was very concerned about its employees and intended to protect them even though it might lead to a violation of a consent decree.

Discussion Case 5-25 provides the student with an excellent example of using an analytical procedure as a substantive test. Students use information on ticket sales to estimate ticket revenue.

Internet Assignments
Internet Assignment 5-26 provides a good exercise for the students to learn more about internal auditing and its governing body, the IIA.
Internet Assignment 5-27 is part of the EarthWear running case. The assignment requires the students to find information on the retail mail order industry.

Practice Insight
Practice Insights provide real-world integration. Practice Insight scenarios are included in each chapter to highlight important and interesting real-world trends and practices. These self-contained insights or scenarios focus on current events, student decision-making, and professional problem solving.