

7 AUDIT PLANNING AND RISK ASSESSMENT

(LECTURE A611 – 12.32 MINUTES)

With December 2017 year-ends fast approaching, attention will be being turned to the planning of these assignments. The planning and risk assessment phase of the audit is a critical aspect as it allows the auditor the opportunity to identify those areas of the financial statements which are prone to the risk of material misstatement; identify appropriate staff members to be deployed on the assignment and develop procedures to obtain sufficient appropriate audit evidence as a means of reducing audit risk (i.e. the risk that the auditor expresses an inappropriate opinion on the financial statements).

Adequate time should be devoted to the planning and risk assessment phase of the audit and it should not be viewed as a 'tick-box' or compliance exercise. Many audits are criticised by file reviewers and professional bodies, usually because of poor planning which, in turn, results in poor execution of audit procedures.

Audit planning is dealt within in the ISAs (UK) in the 300 series:

- ISA (UK) 300 (Revised June 2016) *Planning an Audit of Financial Statements*;
- ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*;
- ISA (UK) 320 (Revised June 2016) *Materiality in Planning and Performing an Audit*; and
- ISA (UK) 330 (Revised June 2016) and (Revised July 2017) *The Auditor's Responses to Assessed Risks* [note ISA (UK) 330 (Revised July 2017) is effective for audits of financial statements for periods commencing on or after 15 December 2017].

This course will not be examining all of the above ISAs (UK) in turn, but will take a look at some of the critical areas of ISA (UK) 300 which should be applied when planning an audit of financial statements.

7.1 *Why bother with planning?*

The first response to this question is that it is compulsory under the UK ISAs. Auditors cannot go into an audit blind because if they do, audit risk is increased significantly. It is unfortunately not uncommon for audit files to be severely criticised by file reviewers and professional bodies for either a lack of audit planning or, in some more serious cases, no planning. Practitioners sometimes respond with '*I have acted for the client for several years and have a full understanding of the client and its systems*'. While this may be true, if the planning is not carried out properly, the firm cannot demonstrate that it has complied with the ISAs (UK) – this will be the case if the planning is not adequately documented. If the firm cannot demonstrate they have complied with the ISAs (UK) they risk heavy sanctions coming their way – in some cases, professional bodies will remove an audit firm's audit practising certificate and impose a heavy fine for doing so.

When an audit firm carries out adequate audit planning, the benefits are as follows:

- It helps the auditor to devote appropriate attention to important areas of the audit.
- It helps the auditor identify and resolve potential problems on a timely basis.
- It helps the auditor properly organise and manage the engagement so that it is performed in an effective and efficient manner.
- It assists in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- It facilitates the direction and supervision of engagement team members and the review of their work.
- It assists, where applicable, in coordination of work done by auditors of components and experts.

The overall objective of ISA (UK) 300 is for the auditor to plan the audit so that it will be executed in an effective manner. This, of course, has the added benefit that efficient audits will also be cost-effective for the audit firm, hence budgets will not be exceeded and firm losses will be minimised.

7.2 Preliminary planning activities

At the outset, the auditor must consider whether there are any factors which may impede on the firm's independence and objectivity. In other words, they must consider whether they are sufficiently independent to carry out the engagement and whether the firm's quality control procedures comply with the requirements of ISA (UK) 220 (Revised June 2016) *Quality Control for an Audit of Financial Statements*.

The auditor must be satisfied that the firm's procedures regarding acceptance and continuance of audit engagements have been carried out together with the conclusions thereon. In situations where information comes to light which would have resulted in the firm declining the audit engagement had the information been known earlier, the engagement partner informs the audit firm so that appropriate action can be taken. Where the firm is a sole practitioner, hence the principal is also the senior statutory auditor, the principal considers the most appropriate action to take in light of the new information acquired.

The auditor must also consider the requirements of the FRC's Ethical Standard (the 2016 edition) and whether compliance can be achieved.

Finally, the auditor must review the contents of the engagement letter and determine whether they are in accordance with the requirements of ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements*. This includes considering whether the client needs reminding of the terms of the engagement and whether it needs to be updated. It is surprising how many engagement letters for audit assignments are out-of-date!

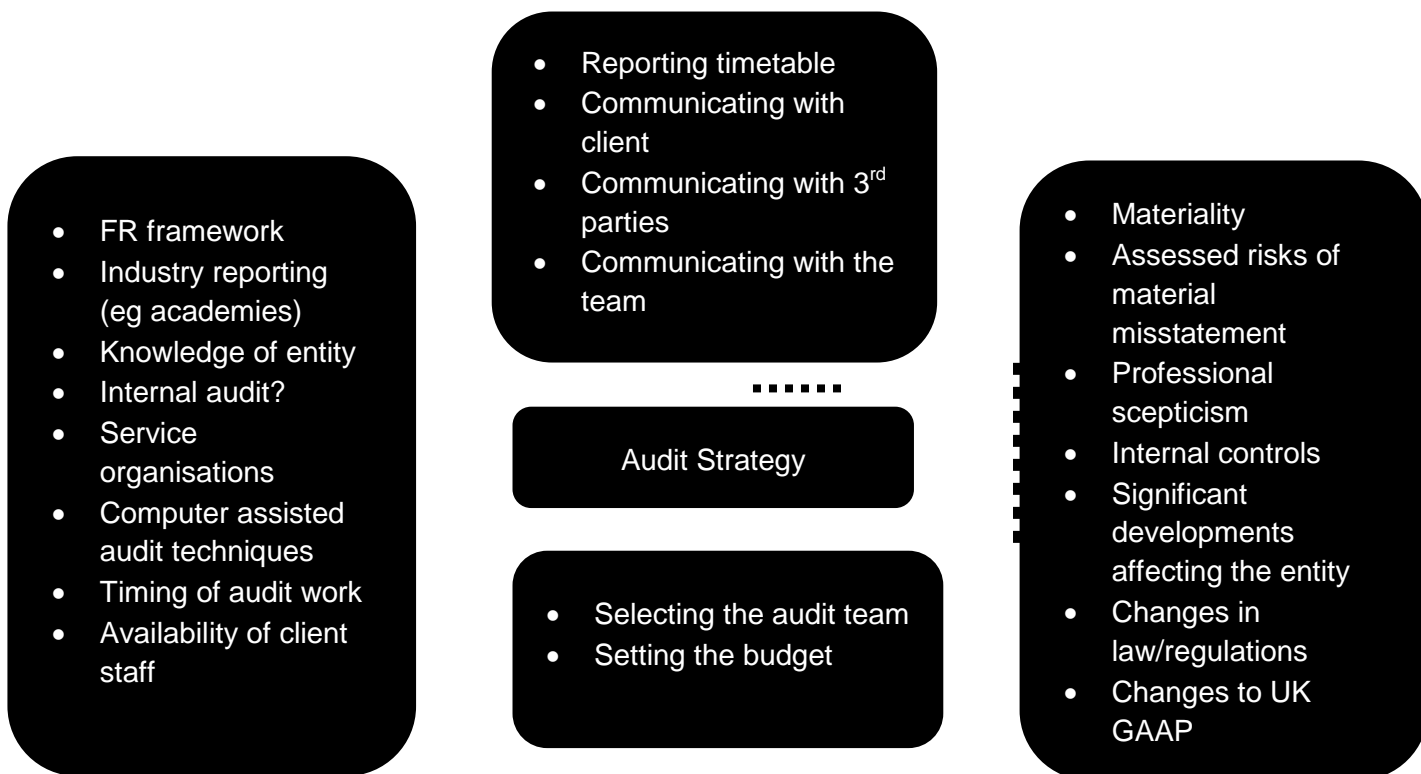
Where engagement letters are concerned, these must be in accordance with ISA (UK) 210 (Revised June 2016) and should be tailored to be client-specific wherever possible. In addition, it is important to ensure that the 'preconditions' of the audit are present (see paragraph 6 of ISA (UK) 210).

7.3 *Audit strategy*

An important part of the planning phase of the audit is for the auditor to develop an audit strategy. The audit strategy sets the scope, timing and direction of the audit and to achieve this the auditor:

- identifies the characteristics of the engagement;
- ascertains the reporting objectives so as to plan when the audit will be carried out and what forms of communication will be required;
- significant in directing the efforts of the audit team;
- consider the results of preliminary activities and whether knowledge gained by undertaking other work by the engagement partner for the entity is relevant; and
- deciding on the nature, timing and extent of resources to deploy on the assignment.

Developing the audit plan can be seen diagrammatically as follows:



The audit strategy is a 'high level' issue which allows the auditor to 'drill down' into the entity to help them develop the audit plan.

7.4 Audit plan

Once the audit strategy has been developed, the detailed audit plan can be drawn up. The idea of the audit plan is to address how the matters in the audit strategy (i.e. the diagram above) will be applied. Thus, the audit strategy sets the overall approach to the audit, whereas the audit plan deals with the operating level of how the audit strategy will be achieved.

Paragraph 9 of ISA (UK) 300 (Revised June 2016) says that the audit plan must include a description of:

- (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA (UK) 315 (Revised June 2016).
- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA (UK) 330 (Revised June 2016).
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs (UK).

Once the audit strategy and audit plan have been developed, they must be updated as necessary as the audit progresses. In other words, they are not forgotten about when the planning is completed!

Where any significant changes are made during the engagement to the overall audit strategy or the audit plan, the reasons for such changes must be documented.

7.5 Assessing risks

An integral part of planning involves assessing risks. Risks usually comprise of three aspects:

- (a) business risk;
- (b) audit risk; and
- (c) the risk of material misstatement.

7.5.1 Business risk

The term 'business risk' is defined in ISA (UK) 315 (Revised June 2016) as follows:

*'A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives or strategies.'*¹

Business risk is a much broader concept than audit risk. At the planning phase of the assignment, firms should document the background of the business and then assess the business risks. Business risks are often linked to inherent risk, which itself is a component of audit risk. External circumstances often give rise to business risk, such as a company which operates in a high-tech industry and technological developments may mean that a company's inventory (stock) becomes obsolete quite quickly.

¹ ISA (UK) 315 (Revised June 2016) paragraph 4(b)

File reviews have indicated that business risks are not being documented adequately enough. Once the auditor has considered the relevant business risks, they should then consider whether these risks impact on any particular areas at the assertion level. For example, if a company's stock may become obsolete quickly, the auditor's attention should be devoted to the valuation of this inventory and whether write-downs to estimated selling price less costs to complete and sell may be necessary.

7.5.2 Audit risk

Audit risk is the risk that the auditor will express an inappropriate opinion on the financial statements and is the broadest level of risk because it includes both inherent risk (which is the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement before considering any related controls present at the entity) and detection risk. Detection risk is the risk that the auditor's procedures will not detect a misstatement which exists and which could be material. Detection risk is then sub-divided into:

- **sampling risk** which is the risk that the auditor's conclusion based on a sample is different from the conclusion which would be reached if the whole population were tested; and
- **non-sampling risk** which is the risk that the auditor's conclusion is inappropriate for any other reasons, such as performing inappropriate procedures or failing to recognise a misstatement.

7.5.3 Risk of material misstatement

The risk of material misstatement is the risk that the financial statements contain a material misstatement prior to the auditor starting the audit. The risk of material misstatement comprises both inherent risk and control risk (control risk being the risk that a misstatement could occur which could be material and which will not be corrected, or detected and corrected, on a timely basis by the entity's internal control system).

When assessing the risk of material misstatement, it is vital to consider the specific impact of the risk on the financial statements, including whether the potential misstatement is an over or understatement of amounts recognised in the financial statements, or whether the risk relates to a disclosure requirement in the notes to the financial statements.

An entity with a poor control environment will invariably have a higher risk of material misstatement than an entity with a sound control environment. However, auditors should keep in mind that just because an entity may have a good internal control environment, it will not completely eradicate the risk of material misstatement. For example, management override of internal control!

To reduce audit risk, the auditor must ensure that they carry out risk assessment processes carefully (rather than approach the process as a tick-box exercise) and ensure they devise appropriate responses to risks at the planning stage.

7.5.4 Responses to risk

At the planning stage, the auditor will first consider the business risks pertinent to the client and how these risks (could) impact the financial statements. Audit risks are then considered for which appropriate responses should be designed by the auditor. Typical auditor's responses to risk would be:

- assigning experienced audit staff to areas which contain a higher risk of material misstatement;
- performing more regular reviews of audit work and increasing supervision levels;
- increased unpredictability in sample selection;
- changing the nature, timing and extent of audit procedures;
- performing increased substantive testing on key high risk areas; and
- emphasising the need for the audit staff to maintain professional scepticism throughout the entire audit.

The final point concerning professional scepticism has been in the headlines a lot over the years and audit firms are frequently criticised for failing to maintain professional scepticism. Audit files should also demonstrate that the audit team has maintained professional scepticism; for example, by challenging management's estimates and judgements and considering how fraud COULD arise within the entity, rather than just concluding (at the planning stage) that fraud will not arise.

ISA (UK) 200 (Revised June 2016) defines 'professional scepticism' (the standard spells it 'skepticism') as follows:

*'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.'*²

Professional scepticism requires the auditor to be alert to:

- Audit evidence which may contradict other audit evidence.
- Fraud or conditions which may give rise to fraud risk factors.
- Information that brings into question the reliability of documents and responses to enquiries to be used as audit evidence.
- Circumstances which may require the auditor to devise entity-specific audit procedures beyond those required by the UK ISAs.

² ISA (UK) 200 (Revised June 2016) **Professional skepticism**

Example – Professional scepticism

The audit of Company A Ltd (a builders merchant) is currently underway and this is the first year the company has engaged you as the firm's auditors. The company reports under FRS 102 and is a large company in the eyes of the Companies Act 2006. The audit of the 2017 financial statements has just started with the planning exercise and the draft financial statements show a 35% increase in turnover and pre-tax profit which is consistent with the previous year.

During the course of the audit of the opening balances from the predecessor auditor's working papers file, the audit senior notes a provision for liabilities amounting to £8m, which has not moved since the previous year's audit (the previous year's auditor's report was unqualified). The predecessor auditor's working papers only show a lead schedule worded 'Provision for potential damages £8m (2015: £8m)' – there is no other audit evidence available.

The audit senior queries this provision with the finance director who provides the following response:

'We operate in a very litigious state nowadays. We take pride in the fact that we are a prudent entity, but sometimes may not get everything right first time. In light of this, I have made a provision for potential claims against the company that may come in the future. I'm not sure if that is what your accounting laws allow, but we have always done this and will continue to do so in the future.'

On first glance, it is becoming clear that the £8m provision is nonsense as you cannot recognise a provision unless there is an obligation as a result of a past event (the unqualified audit opinion in the previous year is also questionable if the £8m was material either in isolation or in aggregate as there is no other audit evidence on file). This provision is for unknown future claims against the entity. The audit team must apply professional scepticism where this client is concerned as there could be other items in the financial statements which become questionable, such as:

- incorrect cut-offs for sales (hence the 35% increase in turnover);
- additional provisions which have reduced profit to the same level as the prior year despite a 35% increases in turnover;
- fraud;
- fraudulent financial reporting (i.e. a focus on the bottom line and then working upwards to achieve a desired financial reporting position);
- a lack of understanding of accounting and accounting standards by those preparing the financial statements; and
- material misstatements in the prior year (and beyond).

Using the above as a typical example, the planning and risk assessment should incorporate a high risk of material misstatement, thus substantive procedures should be increased in those areas judged high risk by the auditor (which may be most areas).