

the business risk-based approach to an audit and audit planning

relevant to CAT Paper 8 and ACCA Qualification Papers F8 and P7 (INT and UK)

planning

■ In the February 2008 issue of *student accountant*, I explained the risk-based approach to auditing. In this second article, I explain the business risk-based approach in more detail, and explain the activities that are undertaken as part of audit planning when this approach is adopted.

As with any other approach to auditing financial statements, if an auditor adopting a business risk-based approach wants to ensure an effective and efficient audit then they must ensure that the audit work is properly planned. Students may already be aware of the statements 'proper planning prepares for proper performance', and 'poor planning prepares for poor performance', which are particularly pertinent when applied to an audit situation. However, the question remains as to what constitutes 'proper planning' with regard to an audit assignment.

ISA 300, *Planning an Audit of Financial Statements* (UK candidates should refer to ISA 300 (UK and Ireland), *Planning an Audit of Financial Statements*), establishes standards and provides guidance on the considerations and activities applicable to planning an audit of financial statements. The ISA sets out in detail the planning activities that an auditor should undertake, and students are encouraged to read the international or UK standard (as appropriate) in order to obtain detailed knowledge of this area. In summary, audit planning activities comprise:

- establishing an overall audit strategy
- developing an audit plan for the audit in order to reduce audit risk to an acceptably low level

- continuously updating the overall audit strategy and the audit plan throughout the course of the audit assignment
- directing and supervising the audit team and reviewing their work
- documenting the overall audit strategy and the audit plan
- communicating with those charged with governance and management of the organisation being audited.

This article explains each of these planning activities in the context of an audit assignment where a business risk-based approach to the audit has been adopted. To help explain and illustrate the practical application of these activities, I have used a modified version of the scenario used in the CAT Paper 8 (INT) exam, as follows:

Finch Co is an audit client of Tidua Co, and operates eight hotels in various locations around the country. The following information relates to the company's operations during the year ended 31 March 2008.

1 *Following career moves by the ex-managing director and the ex-financial director, two replacement directors were appointed in April 2007. The new managing director has extensive experience of working in the hotel sector and adopts an aggressive and assertive management style, while the new financial director is an unqualified accountant with only limited experience in the hotel sector.*

- 2 *The company's directors, central administration, and accounts department are located at its head office premises, and wage payments to all employees, together with all company supplier payments, are made from there. Accounts staff at each hotel deposit hotel takings into the company's bank account at their local branch of the bank.*
- 3 *The company's accounting system, which comprises fully integrated general, trade payables and trade receivables ledgers, relies on daily sales and accounting information being input into remote terminals at each hotel, for transfer to a secure central computer based in the head office accounts department. The new financial director has changed some of the general controls of the system including those relating to the use of the remote terminals.*
- 4 *The company operates a cash or bank card payment policy for non-corporate customers, with credit terms being offered only to corporate customers.*
- 5 *The remuneration package of each of the company's directors provides for the payment of a bonus based on the profits of the company. Similarly, the remuneration package of each hotel general manager provides for a bonus based on the profits of their hotel.*
- 6 *Independent contractors were employed to construct a new hotel on land already owned by the company. Work commenced in April 2007 and the new hotel began trading in January 2008.*

- 7 *Each hotel offers restaurant, gym, conference and meeting facilities. The company owns all of the hotels' land and buildings. During the year, two hotels were substantially extended to create additional restaurant space, while a swimming pool was constructed at another.*
- 8 *In keeping with company policy, all hotels have ongoing repairs, maintenance and replacement programmes for furnishings and equipment.*
- 9 *In November 2007, food poisoning at one of the company's largest hotels resulted in hospital admission for eight of the hotel's customers. The directors of Finch Co have received legal advice confirming that the company is likely to have to pay compensation to settle the legal claims that have been lodged against it in this regard. However, the claims are unlikely to be settled before December 2008.*

THE ESTABLISHMENT OF AN OVERALL AUDIT STRATEGY

It is important to note that the overall strategy for the audit of the financial statements of Finch Co for the year ended 31 March 2008 sets the scope, timing, and direction of the audit and guides the development of the more detailed audit plan. In accepting that a business risk-based approach is going to be adopted for the audit, specific matters to consider include:

- a the scope of the audit engagement, for example:
 - i hotel industry-specific financial reporting requirements, including the possibility of mandatory reporting to regulators
 - ii the number of hotel locations to be visited by the audit team
 - iii the expected use of audit evidence obtained in prior audits
 - iv the use of information technology by Finch Co, the availability of data (for testing), and the expected use of computer-based audit techniques
 - v the availability of the relevant employees of Finch Co to assist Tidua Co personnel in their audit enquiries.

- b the reporting objectives, timing of the audit, and the communications required, for example:
 - i Finch Co's timetable for reporting to its members with the audited financial statements
 - ii the requirement to update management with the status of the audit work throughout, and the arrangement of meetings to discuss these together with the nature, extent, and timing of the review of work performed
 - iii encouraging communications between the audit team including the nature and timing of the reviews of work performed
 - iv the requirement or expectation to communicate with third parties.
- c the direction of the audit.

Students should appreciate that the matters considered under headings (a) and (b) would be considerations common to the various audit approaches that Tidua Co could adopt for the audit of the financial statements of Finch Co (see my article *A risk-based approach to auditing financial statements* in the February 2008 issue of *student accountant*). Similarly, there would be common considerations to be made with regard to the settings of materiality levels.

The uniqueness of the business risk approach stems from the requirement for auditors to make risk assessments of material misstatement at the financial statement and assertion levels using a 'top down' approach (see my article in the February 2008 issue of *student accountant*).

From the narrative information provided about Finch Co, if Tidua Co adopts a business risk-based approach to the audit of the financial statements of Finch Co for the year ended 30 November 2007, they should be able to identify the inherent risks existent in the financial statements, as listed in **Table 1** on page 46.

Students should note that when identifying the inherent risks arising as a consequence of each business risk, Tidua Co will place particular emphasis on identifying areas of the financial statements where assets could be materially overstated and areas where

liabilities could be materially understated. This is because the existence of either condition could result in the material overstatement of reported profit for the year.

To prevent the business risks identified above from materialising, the directors of Finch Co should have implemented an effective system of internal control, one which demonstrates the various standard attributes with which all auditing students should be familiar (such as segregation of duties, authorisation controls, or application controls). Indeed, it is this system of internal control that Tidua Co would ascertain and evaluate when determining the levels of control risk and overall financial statement risk in existence.

AUDIT PLAN

Before commencing with the detailed planning of the audit, it is imperative for Tidua Co to build up an extensive knowledge of the business of Finch Co. This is because it would be impossible to reliably assess levels of risk without having a full understanding of the company and its environment. Such an understanding demands an appreciation of matters such as the hotel business sector, particular operating issues faced by Finch Co, the company's ethos, its management structure, systems and governance procedures, and its customer and supplier profiles.

Ultimately, Tidua Co will have to ascertain the extent of the substantive procedures they need to carry out before arriving at their audit opinion. Consequently, using the audit risk model, they should consider the level of audit risk they are prepared to accept for the assignment, in conjunction with the deemed level of financial statement risk, and then use the resultant detection risk factor to determine and document the planned levels of substantive procedures. Having completed this task, the firm should then be able to produce an initial timetable of planned work detailing the audit procedures to be carried out, the timing of the work, and the allocation of work to appropriate members of the audit team.

CONTINUOUS UPDATING OF THE OVERALL AUDIT STRATEGY AND THE AUDIT PLAN

As indicated in my February 2008 article,

ISA 300, *Planning an Audit of Financial Statements*, establishes standards and provides guidance on the considerations and activities applicable to planning an audit of financial statements.

no two audit assignments are the same. Consequently, the audit strategy and the detailed planning procedures carried out for the audit of Finch Co's financial statements will differ from those carried out for any other audit. Typically, determining an audit strategy and the planning of an audit are (more often than not) dynamic processes, and students should be aware that the audit procedures which form part of the initial strategy or plan may not be carried out, or, conversely, may be extended as a consequence of findings from initial tests. For example, during the course of an audit, an audit firm may discover fraudulent activity which has been carried out by a director of a company. This discovery would probably result in a change in strategy for the remainder of the audit. Similarly, with regard to Finch Co, while initial risk assessment procedures in the area of non-current assets may have resulted in 'low' financial statement risk, subsequent testing for the existence of non-current assets may have revealed a high incidence of non-existence. Such a revelation would be of major concern to Tidua Co and consequently, initial planned levels of testing for the existence of non-current assets would need to be increased in order to properly conclude as to the accuracy of the non-current assets figures stated in the company's financial statements.

DIRECTION, SUPERVISION, AND REVIEW

Tidua Co should ensure that there is adequate planning as to the nature, timing and extent of direction and supervision of staff engaged on the audit assignment. To a large extent this will depend on the capabilities and competences of the audit team members, the deemed level of complexity of the audit of Finch Co's financial statements, and the risks of material misstatement. Tidua Co can manage the overall level of audit risk by allocating and effectively managing the audit resources necessary to carry out detailed substantive procedures; students should therefore appreciate the importance of resource allocation, by way of audit staffing and support, to this audit assignment.

Given that Finch Co has employed a new managing director and a new financial director during the year, and that these appointments

represent significant business risks for the company, clearly it would be prudent for Tidua Co to ensure that the audit team is comprised of senior and experienced staff who have worked on previous Finch Co audits – or at the very least have good experience of hotel sector audits. According to the deemed level of complexity, audit tasks should be assigned to appropriately experienced team members, and arrangements put in place for the contemporary review of all work by suitably experienced individuals to ensure that audit work is completed as planned and that audit objectives are met.

DOCUMENTATION

Tidua Co should document the overall strategy, and the plan, for the audit of Finch Co's financial statements.

The documentation for the overall strategy of the audit should (normally) take the form of an audit planning memorandum for distribution to all members of the audit team. This memorandum should contain a summary of the strategy – including confirmation of the adoption of a business risk-based approach to the audit. It should also set out key decisions regarding the overall scope, timing, and conduct of the audit.

Documentation for the audit plan should set out the planned nature, timing, and extent of risk assessment procedures, and further audit procedures, at the assertion level, for each material class of transaction, account balance, and disclosure in response to the assessed risks. Ideally, Tidua Co should have a documented programme of work to be carried out (an audit programme), or audit completion checklists designed specifically for the audit of Finch Co's financial statements. If it does not, then the audit manager should tailor any standard programmes or checklists to the specific requirements of the Finch Co audit.

Any significant changes to the original audit strategy or detailed audit plan should be documented by Tidua Co. Where changes are made, reasons should be duly recorded (see 'Continuous updating of the overall audit strategy and the audit plan' above).

Students should note that all planning documentation retained by Tidua Co in connection with this audit should be filed in

the 'Planning' section of the '2008 Current Audit File for Finch Co'.

COMMUNICATIONS WITH THE DIRECTORS OF FINCH CO

Students should appreciate that, irrespective of any regulatory guidance, the requirement for Tidua Co to communicate with the directors of Finch Co in connection with the planning of the audit, is both courteous and plainly necessary in order to improve the efficiency and effectiveness of the audit. Such communication, by way of discussions, would normally cover fundamental points such as the availability of office accommodation for the audit team, the timing of audit procedures (including the dovetailing of work with the availability of Finch Co's staff where their assistance is required), and arrangements to ensure that audit staff will have unfettered access to the company's ICT systems at appropriate times.

Members of the audit team who are in communication with the company's directors should be aware that the directors must have no influence on Tidua Co's audit strategy or audit plan. Therefore they must ensure that discussions with them do not in any way result in the effectiveness of the audit being compromised. For example, when discussing the timing of audit procedures, audit staff should consider whether the predictability of the timing of the audit procedures will compromise their effectiveness.

CONCLUSION

At the beginning of this article I made reference to the question: 'What constitutes proper planning with regard to an audit assignment?'. I have attempted to answer this question by focusing on the topic of audit planning when combined with a business risk-based approach to an audit. I hope that, by careful study of this article, students will gain a better understanding of the various aspects of audit planning when applied with a business risk-based approach to an audit, and will therefore be in a better position to apply these principles to questions on these topics in future CAT and ACCA auditing exams. ■

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TABLE 1: INHERENT RISKS IN THE FINANCIAL STATEMENTS OF FINCH CO

Aspect	Business risk threat	Financial statement (inherent) risk
New managing director (MD) and financial director (FD)	Combination of experienced but aggressive and assertive MD with unqualified and inexperienced FD could lead to misstatements in the financial statements	Profits could be materially overstated/ understated and the financial statements could contain material errors
Eight hotels in various locations	Information forwarded to head office accounts department could be incomplete or erroneous due to the spread of operations; company assets could be misappropriated	Material errors or omissions may exist in revenue and expenditure figures; non-current assets could be overstated
Computer-based accounting system with remote terminals	Inaccurate or incomplete information could be forwarded to head office due to remoteness of IT operations	Material errors or omissions may exist in revenue or expenditure figures
Operation of cash and credit facilities for customers	Cash received at hotels could be misappropriated; bad debts could be incurred	Sales could be understated and receivables could be overstated resulting in under/ overstatement of profits
Remuneration package bonuses are based on profits	Bonuses to which employees are not entitled could be paid	Both profits and entitlement to bonus payment could be overstated
New hotel was constructed during the year	Significant amounts of expenditure during the year could be misappropriated, incorrectly classified, or overstated	Non-current asset values could be overstated, taxation liabilities could be incorrectly stated, current liabilities could be understated
Extensive improvements made to existing hotels	Significant amounts of expenditure during the year could be incorrectly classified or overstated; large sums of unauthorised expenditure could be incurred	Expenditure may have been incorrectly classified between capital expenditure, repairs, and maintenance expenditure; the underlying accounting records may have been fraudulently manipulated, resulting in inaccurate reporting
Ongoing repairs and maintenance expenditure incurred	Significant amounts of expenditure during the year could be incorrectly classified or overstated	Expenditure may have been incorrectly classified between capital expenditure, repairs, and maintenance expenditure, with resultant inaccuracies in the financial statements
Ongoing replacement programmes for furnishings and equipment	Small valuable items of furniture and equipment could be lost due to misappropriation	Non-current assets values could be overstated due to non-existence
Compensation claim due to food poisoning	The company's future existence could be threatened due to a damaged reputation; the company could suffer a large compensation claim	The estimated provision relating to the food poisoning could be understated, resulting in material overstatement of profits