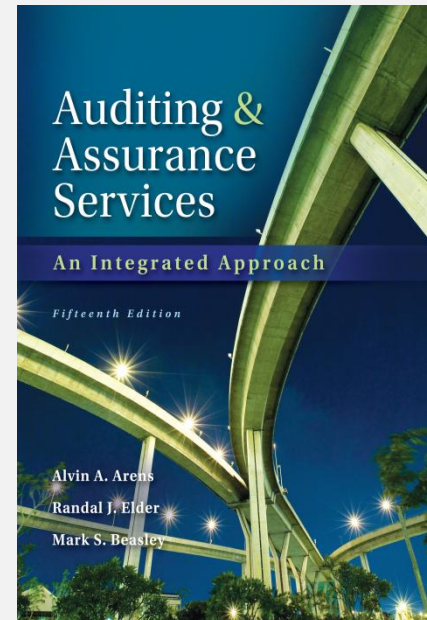


Audit Planning and Analytical Procedures

Chapter 8



Learning Objectives

- 1 Discuss why **adequate audit planning** is essential.
- 2 Make client **acceptance decisions** and perform initial audit planning.
- 3 Gain an understanding of the client's business and industry.
- 4 Assess client business risk.

Learning Objectives

- ⑤ Perform preliminary analytical procedures.
- ⑥ State the purposes of analytical procedures and the timing of each purpose.
- ⑦ Select the most appropriate analytical procedure from among the five major types.
- ⑧ Compute common financial ratios.

1

Discuss why adequate audit planning is essential.

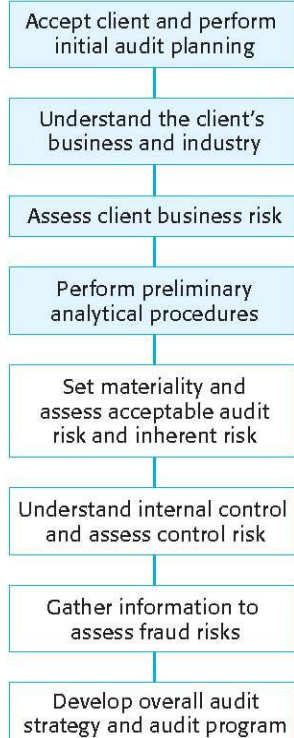
Three Main Reasons for Planning

1. To obtain **sufficient appropriate evidence** for the circumstances
2. To help keep audit **costs reasonable**
3. To avoid **misunderstanding** with the client

Three Main Reasons for Planning

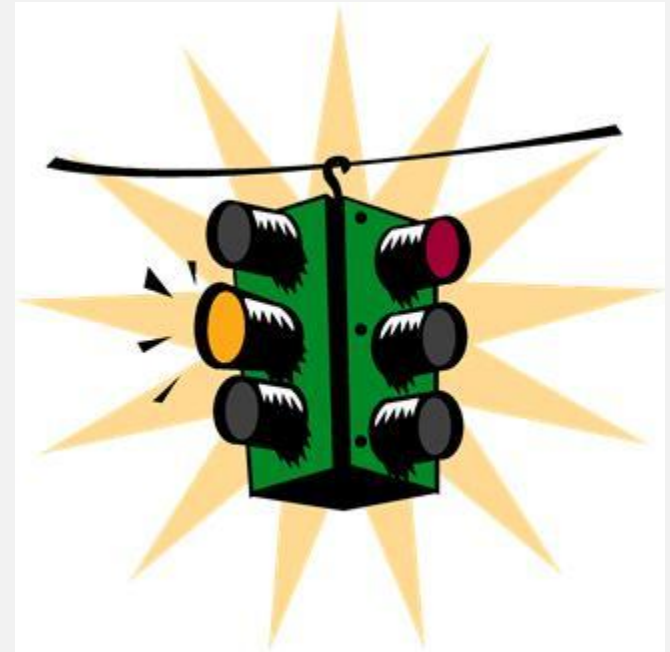
FIGURE 8-1

Planning an Audit and Designing an Audit Approach



Risk Terms

- Acceptable audit risk
- Inherent risk



2

Make client acceptance decisions and perform initial audit planning.

Initial Audit Planning

1. Client acceptance and continuance
2. Identify client's reasons for audit
3. Obtain an understanding with the client
4. Develop overall audit strategy

Client Acceptance and Continuance

➤ New client investigations

- If previously audited, the new auditor is required to communicate with the predecessor auditor
- Client permission required

➤ Continuing clients

- Annual evaluations whether to continue based on issues, fees, and client integrity

Identify Reasons for the Audit

- Two major factors affecting acceptable risk
 - Likely statement users
 - Intended uses of the statements

- Likely to accumulate more evidence for companies that are
 - Publicly held
 - Have extreme indebtedness
 - Likely to be sold

Obtaining an Understanding with the Client

- Engagement terms should be understood between CPA and client.
- Standards require an engagement letter describing:
 - objectives
 - responsibilities of auditor and management
 - schedules and fees
- Informs client that auditor cannot guarantee all acts of fraud will be discovered
- See figure 8-2

Develop Overall Audit Strategy

- Preliminary audit strategy should consider
 - client's business and industry
 - material misstatement risk areas
 - number of client locations
 - past effectiveness of controls
- Preliminary strategy helps auditor determine resource requirements and staffing
 - staff continuity
 - need for specialists

3

Gain an understanding of the client's business and industry.

Understanding of the Client's Business and Industry

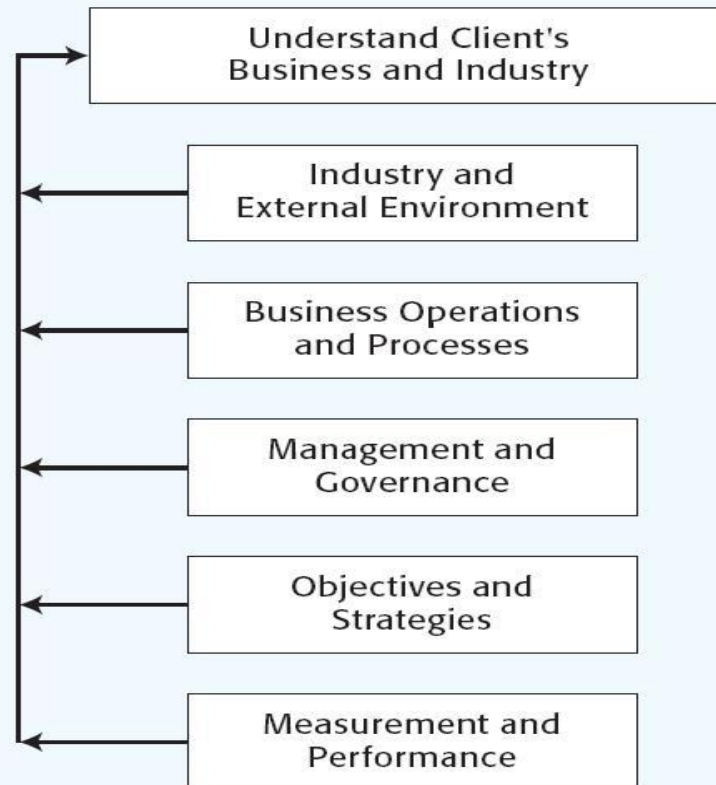
Client business risk is the risk that the client will fail to meet its objectives.

- Declines in economic conditions
- Information technology
- Global operations
- Human capital

Understanding of the Client's Business and Industry

FIGURE 8-3

Strategic Systems Understanding of the Client's Business and Industry



Industry and External Environment

Reasons for obtaining an understanding of the client's industry and external environment:

1. Risks associated with specific industries
2. Inherent risks common to all clients in certain industries
3. Unique accounting requirements

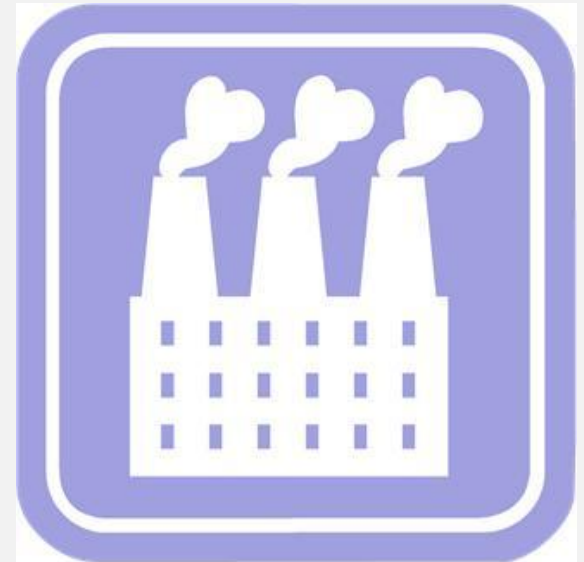
Business Operations and Processes

Factors the auditor should understand:

- Major sources of revenue
- Key customers and suppliers
- Sources of financing
- Information about related parties

Tour the Plant and Offices

Touring the physical facilities enables the auditor to assess asset safeguards and interpret accounting data related to assets.



Identify Related Parties

- Affiliated companies
- Principal owners of the client
- Any other party with which the client deals
- A party who can influence management or client policies

Management and Governance

Governance includes:

- Organizational structure
- Board activities
- Audit committee activities.

Governance insights:

- Corporate charter and bylaws
- Code of ethics
- Meeting minutes

Management establishes the strategies and processes followed by the client's business.

Code of Ethics

In response to the Sarbanes-Oxley Act, the SEC now requires each public company to disclose whether it has adopted a code of ethics that applies to senior management.

The SEC also requires companies to disclose amendments and waivers to the code of ethics.

Client Objectives and Strategies

Strategies are approaches followed by the entity to achieve organizational objectives.

Auditors should understand client objectives.

- Financial reporting reliability
- Effectiveness and efficiency of operations
- Compliance with laws and regulations

Measurement and Performance

The client's performance measurement system includes key performance indicators. Examples:

- market share
- sales per employee
- unit sales growth
- Web site visitors
- same-store sales
- sales/square foot

Performance measurement includes ratio analysis and benchmarking against key competitors.



Assess client business risk.

Assess Client Business Risk

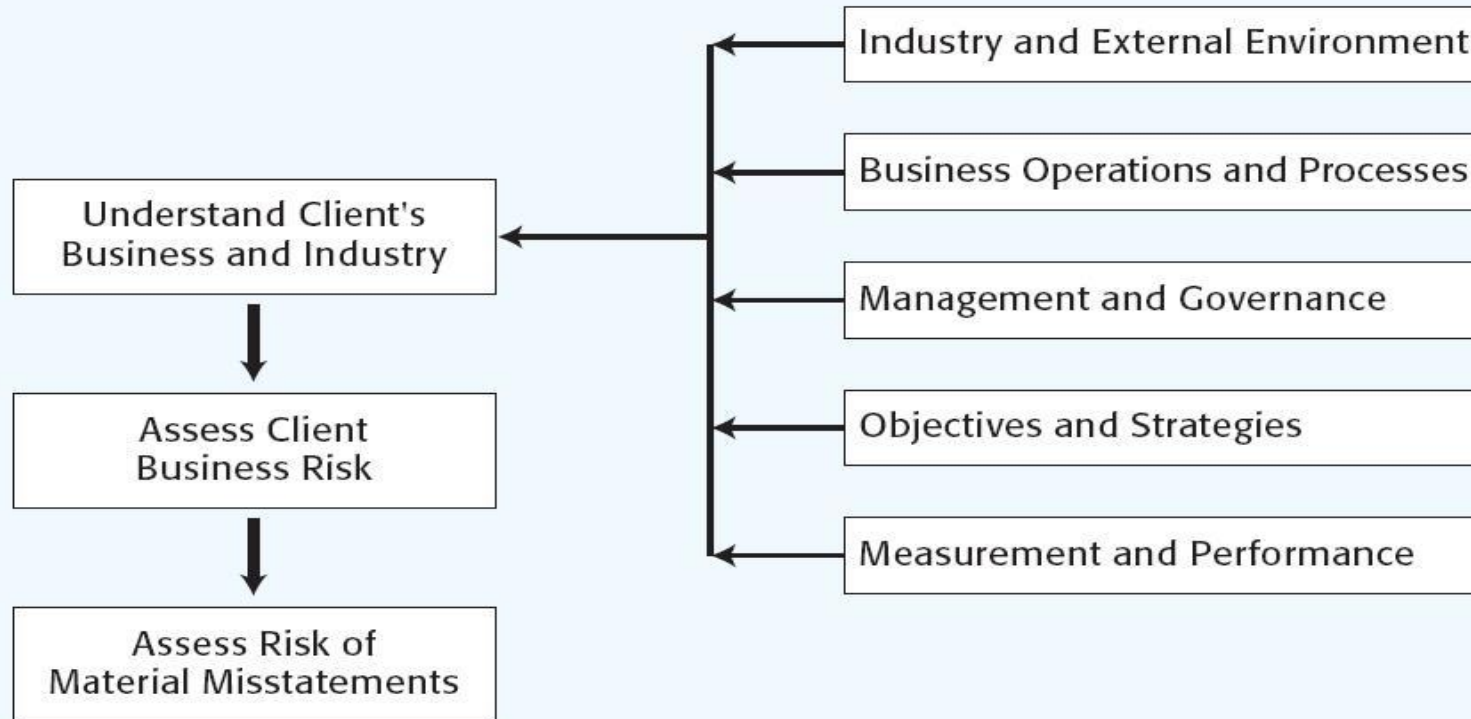
Client business risk is the risk that the client will fail to achieve its objectives.

- What is the auditor's primary concern?
- Material misstatements in the financial statements due to client business risk

Client's Business, Risk, and Risk of Material Misstatement

FIGURE 8-4

Understanding the Client's Business and Industry, Client Business Risk, and Risk of Material Misstatement



Sarbanes-Oxley Act

Management must certify it has designed disclosure controls and procedures to ensure that material information about business risks is made known to them.

Management must certify it has informed the auditor and audit committee of any significant control deficiencies.

5

Perform preliminary analytical procedures.

Preliminary Analytical Procedures

Comparison of client ratios to industry or competitor benchmarks provides an indication of the company's performance.

Preliminary tests can reveal unusual changes in ratios.

Examples of Planning Analytical Procedures

| TABLE 8-1 Examples of Planning Analytical Procedures | | | | |
|--|-------------------------------|------------------------------|-------------------------------|------------------------------|
| Selected Ratios | Hillsburg 12/31/13 | Industry 12/31/13 | Hillsburg 12/31/12 | Industry 12/31/12 |
| Short-Term Debt-Paying Ability | | | | |
| Cash ratio | 0.06 | 0.22 | 0.06 | 0.20 |
| Quick ratio | 1.57 | 3.10 | 1.45 | 3.00 |
| Current ratio | 3.86 | 5.20 | 4.04 | 5.10 |
| Liquidity Activity Ratios | | | | |
| Accounts receivable turnover | 7.59 | 12.15 | 7.61 | 12.25 |
| Days to collect accounts receivable | 48.09 | 30.04 | 47.96 | 29.80 |
| Inventory turnover | 3.36 | 5.20 | 3.02 | 4.90 |
| Days to sell inventory | 108.63 | 70.19 | 120.86 | 74.49 |
| Ability to Meet Long-Term Obligations | | | | |
| Debt to equity | 1.73 | 2.51 | 1.98 | 2.53 |
| Times interest earned | 3.06 | 5.50 | 3.29 | 5.60 |
| Profitability Ratios | | | | |
| Gross profit percent | 27.85 | 31.00 | 27.70 | 32.00 |
| Profit margin | 0.05 | 0.07 | 0.05 | 0.08 |
| Return on assets | 0.09 | 0.09 | 0.08 | 0.09 |
| Return on common equity | 0.26 | 0.37 | 0.24 | 0.35 |

Summary of the Parts of Auditing Planning

A major purpose is to gain an understanding of the client's business and industry.

Planning an Audit and Designing an Audit Approach

- Set materiality and assess acceptable audit risk and inherent risk.
- Understand internal control and assess control risk
- Gather information to assess fraud risks
- Develop overall audit strategy and audit program



6

State the purposes of analytical procedures and the timing of each procedure.

Analytical Procedures

Analytical procedures may be performed at any of three times during an engagement.

1. Required in the planning phase
2. Often done during the testing phase
3. Required during the completion phase

Timing and Purposes of Analytical Procedures

FIGURE 8-6

Timing and Purposes of Analytical Procedures

| Purpose | Phase | | |
|---|------------------------------|-------------------|--------------------------------|
| | (Required) Planning Phase | Testing Phase | (Required) Completion Phase |
| Understand the client's business and industry | Primary purpose | | |
| Assess going concern | Secondary purpose | | Secondary purpose |
| Indicate possible misstatements (attention directing) | Primary purpose | Secondary purpose | Primary purpose |
| Reduce detailed tests | Secondary purpose | Primary purpose | |



Select the most appropriate analytical procedure from among the five major types.

Five Types of Analytical Procedures

Compare client data with:

1. Industry data
2. Similar prior-period data
3. Client-determined expected results
4. Auditor-determined expected results
5. Expected results using nonfinancial data.

Compare Client and Industry Data

| | <u>Client</u> | | <u>Industry</u> | |
|--------------------|---------------|-------|-----------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| Inventory turnover | 3.4 | 3.5 | 3.9 | 3.4 |
| Gross margin | 26.3% | 26.4% | 27.3% | 26.2% |

Internal Comparisons

TABLE 8-2

Internal Comparisons and Relationships

| Ratio or Comparison | Possible Misstatement |
|---|---|
| Raw material turnover for a manufacturing company | Misstatement of inventory or cost of goods sold or obsolescence of raw material inventory |
| Sales commissions divided by net sales | Misstatement of sales commissions |
| Sales returns and allowances divided by gross sales | Misclassified sales returns and allowances or unrecorded returns or allowances subsequent to year-end |
| Bad debt expense divided by net sales | Misstatement in the allowance for bad debts |
| Each of the individual manufacturing expenses as a percent of total manufacturing expense | Significant misstatement of individual expenses within a total |

Compare Client Data with Similar Prior Period Data

| | 2014 | | 2013 | |
|------------------------|------------------|-------------------|------------------|-------------------|
| | (000) Prelim. | % of Net sales | (000) Prelim. | % of Net sales |
| Net sales | \$143,086 | 100.0 | \$131,226 | 100.0 |
| Cost of goods sold | <u>103,241</u> | <u>72.1</u> | <u>94,876</u> | <u>72.3</u> |
| Gross profit | \$ 39,845 | 27.9 | \$ 36,350 | 27.7 |
| Selling expense | 14,810 | 10.3 | 12,899 | 9.8 |
| Administrative expense | 17,665 | 12.4 | 16,757 | 12.8 |
| Other | <u>1,689</u> | <u>1.2</u> | <u>2,035</u> | <u>1.6</u> |
| Earnings before taxes | \$ 5,681 | 4.0 | \$ 4,659 | 3.5 |
| Income taxes | <u>1,747</u> | <u>1.2</u> | <u>1,465</u> | <u>1.1</u> |
| Net income | \$ 3,934 | 2.8 | \$ 3,194 | 2.4 |



Compute common financial ratios.

Common Financial Ratios

- Short-term debt-paying ability
- Liquidity activity ratios
- Ability to meet long-term debt obligations
- Profitability ratios

Short-term Debt-paying Ability

Cash ratio

$$= \frac{(\text{Cash} + \text{Marketable securities})}{\text{Current liabilities}}$$

Quick ratio

$$= \frac{(\text{Cash} + \text{Marketable securities} + \text{Net accounts receivable})}{\text{Current liabilities}}$$

Current ratio

$$= \frac{\text{Current assets}}{\text{Current liabilities}}$$

Liquidity Activity Ratios

Accounts receivable
turnover

$$= \frac{\text{Net sales}}{\text{Average gross receivables}} \times \frac{365 \text{ days}}{1}$$

Days to collect
receivable

$$= \frac{365 \text{ days}}{\text{Accounts receivable turnover}}$$

Inventory
turnover

$$= \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

Days to sell
inventory

$$= \frac{365 \text{ days}}{\text{Inventory turnover}}$$

Ability to Meet Long-term Debt Obligation

$$\text{Debt to equity} = \frac{\text{Total liabilities}}{\text{Total equity}}$$

$$\text{Times interest earned} = \frac{\text{Operating income}}{\text{Interest expense}}$$

Profitability Ratios

Earnings
per share

$$= \frac{\text{Net income}}{\text{Average common shares outstanding}}$$

Gross profit
percent

$$= \frac{(\text{Net sales} - \text{Cost of goods sold})}{\text{Net sales}}$$

Profit
margin

$$= \frac{\text{Operating income}}{\text{Net sales}}$$

Profitability Ratios

Return on
assets

$$= \frac{\text{Income before taxes}}{\text{Average total assets}}$$

Return on
common
equity

$$= \frac{(\text{Income before taxes} \\ - \text{Preferred dividends})}{\text{Average stockholders' equity}}$$

Summary of Analytical Procedures

Compare ratios of recorded amounts to auditor expectations.

Used in planning to understand client's business and industry.

Used throughout the audit

- to identify possible misstatements
- reduce detailed tests
- assess going-concern issues.