OVERVIEW OF THE AUDIT PROCESS AND PRELIMINARY ACTIVITIES

Objectives:

At the end of this lesson, students should be able to discuss:

1. The responsibilities of different parties
2. The different categories and types of management assertions
3. The activities conducted in performing a financial statement audit
4. The audit process
5. The process of accepting or continuing an audit client relationships
6. The process of agreeing on the terms of the audit engagement
7. The form and content of the engagement letter
8. The considerations taken in accepting a change in an engagement
9. The different categories and types of audit procedures

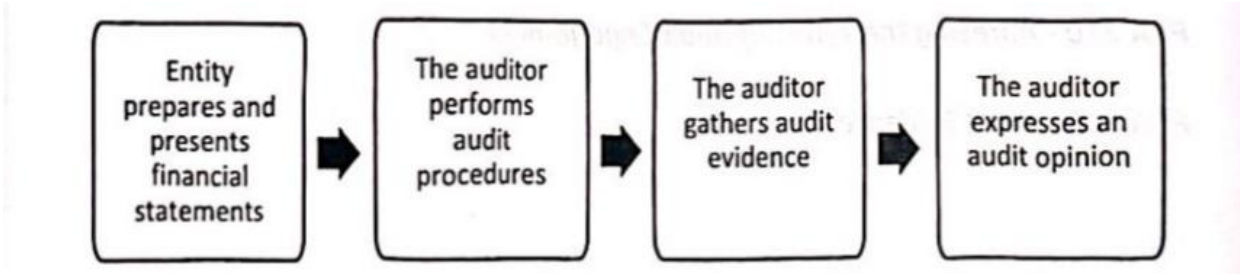
Relevant references:

PSA 200 - Overall Objectives of the Independent Auditor and the Conduct of an

Audit in Accordance with International Standards on Auditing

PSA 210 - Agreeing the Terms of Audit Engagement

PSA 500 - Audit Evidence



Responsibilities of the Different Parties

A. Management and TCWG

1. Preparation and presentation of the financial statements in accordance with the applicable financial reporting framework.
2. Design, implementation and maintenance of internal control.
3. To provide the auditor with:

   i. Access to all information

   ii. Additional information that the auditor may request

   iii. Unrestricted access to persons within the entity

B. Auditor

1. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error
2. To report on the financial statements, and communicate as required by the PSA

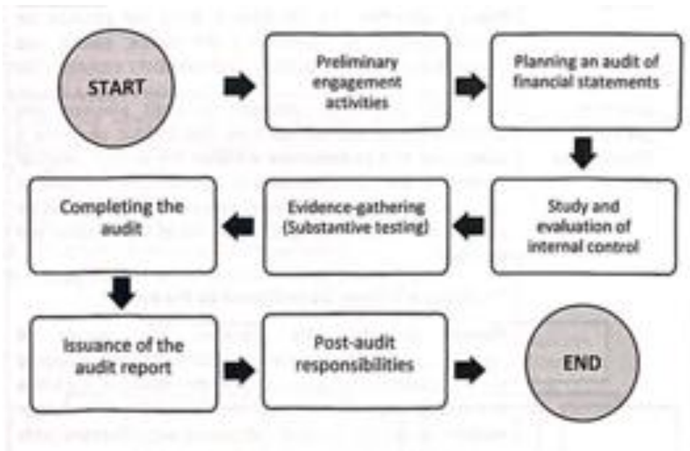
Management Assertions

The financial statements are considered as assertions or representations made by the entity, through its management and those charged with governance, as appropriate. These assertions may be explicitly or implicitly included in the financial statements.

Category	Assertions
Classes of Transactions and and events related disclosures (POCCAC)	• Presentation - transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable. • Occurrence - transactions, and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. • Completeness - all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. • Cutoff - transactions and events have been recorded in the correct accounting period. • Accuracy - amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. • Classification - transactions and events have been recorded in the proper accounts.
Account balances and related Disclosures (PACER C)	• Presentation - assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable. • Accuracy, valuation, and allocation - assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described. • Completeness - all assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures have been included in the financial statements. • Existence - assets, liabilities, and equity interests exist. • Rights and obligations - the entity holds or controls the rights to assets, and liabilities are the obligations of the entity. • Classification - assets, liabilities, and equity interests have been recorded in the proper accounts.

Audit Process

Being a systematic process, an audit engagement is performed using an ordered or structured series of steps. This process is commonly called “**AUDIT PROCESS**".



Preliminary engagement activities

- This phase will require a decision from the auditor on whether or not to accept a new client or continue a relationship with an existing one.
- Evaluation of the auditor's qualification, and the integrity and auditability of the client's financial statements.
- To minimize the likelihood of being associated with a client whose management lacks integrity

Planning an audit of financial statements

- Audit planning involves the development of an overall audit strategy, audit plan, and audit program.
- A preliminary assessment of risk and materiality is also made during this phase.
- To assess the different risks associated with the audit to determine the nature, timing, and extent of further audit procedures necessary to be perform

Study and Evaluation of Internal Control

- The auditor studies and evaluates these controls to establish a basis for reliance on internal control in determining the nature, timing, and extent of audit procedures to be performed.

Evidence-Gathering (Substantive Testing)

- Using information from planning and internal control evaluations, the auditor performs substantive tests to determine whether the entity's financial statements are presented fairly in accordance with financial reporting standards.
- Analytical procedures or tests of details of transactions and balances
- To ascertain the degree of correspondence between the financial statements prepared by management and the financial reporting framework

Completing the Audit

- Wrapping-up procedures are performed, conclusions are reached, and an overall opinion is formed.
- To assist the auditor in assessing whether the conclusion reached is consistent with the evidence gathered.

Issuance of the Audit Report

- The auditor formulates an opinion on the financial statements and states their conclusion regarding the fairness of the financial statements.
- To communicate the conclusions reached by the auditor to various intended users.

Post-Audit Responsibilities

- After completion of the audit engagement, the auditor performs procedures that will enable him/her to identify areas for improvement in the current and future engagements
- To assess and evaluate the quality of services delivered by the engagement team and to identify areas for improvement in current and future engagements.

PRELIMINARY ENGAGEMENT ACTIVITIES MAJOR AUDIT PROCEDURES

In deciding whether to accept or reject an engagement, the auditor's firm should consider the following:

- Its competence
- Its independence
- Its ability to serve the client properly and
- Auditability of the prospective client
- Integrity of the prospective client's management

1. **Obtain a preliminary knowledge of the client's business and industry to determine whether the auditor has the degree of competence required by the engagement.**

This means that the auditor can only accept engagements whose requirements are within the auditor's capacity and capability.

2. **Consider whether there are any threats to the firm's independence and objectivity, and if so, whether adequate safeguards can be established.**

- **Independence of mind** is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment.
- **Independence in appearance** is the avoidance of facts and circumstances that would make an informed third party, or a member of the audit team to conclude that the integrity, objectivity, or professional skepticism of the auditor had been compromised.

3. Evaluate the firm's ability to serve the prospective client.

The firm should consider its resources (e.g. personnel) in evaluating whether the firm has the ability to serve the prospective client properly.

4. Evaluate auditability.

Accounting records, documents and other information that supports the client's financial statements should be made available to the auditor. The absence these raises significant doubt about the client's auditability.

5. Investigate the integrity of the prospective client's management

The main objective of this procedure is to minimize the likelihood of being associated with a client whose management lacks integrity.

Investigation of the integrity of the client's management may be performed through reading published articles, inquiry to appropriate parties, or communication with the previous auditor (previously called **predecessor auditor**) subject to the client's permission.

Note: Every time communication is made to parties other than the client, the auditor shall seek permission from the client and document the items discussed.

Matters to be discussed with the previous auditor include the following:

a. Reasons for change in auditors

b. Integrity of the management, and

c. Disagreements between the previous auditor and management

6. Agree on the terms of the engagement and prepare an engagement letter.

After considering the above factors, the auditor shall decide whether to accept or decline the proposed audit engagement.

If the auditor decides to accept the engagement, the auditor and the client shall agree on the terms

of the engagement.

ACCEPTANCE OF AN ENGAGEMENT

The auditor should accept or continue an audit engagement only when:

a. The preconditions for an audit are present; and

b. There is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Preconditions for an Audit

- Acceptable financial reporting framework of the client
- Agreement of management and, where appropriate, those charged with governance to as their responsibilities.

If the client impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement

AGREEING TO THE TERMS OF AUDIT ENGAGEMENTS

The agreed terms shall be recorded in an audit engagement letter or other suitable form of written agreement.

It is in the interest of both the entity and the auditor that the auditor sends an engagement letter, preferably before the commencement of the audit to help avoid misunderstandings with respect to the audit.

Form and Content of Engagement Letter

a. The objective and scope of the audit of the financial statements

b. The responsibilities of the auditor

c. The responsibilities of management

d. Identification of the applicable financial reporting framework for the preparation of the financial statements, and

e. Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

- The auditor may also wish to include in the letter basis in which fees are computed.

Exhibit 4-3 **Illustrative engagement letter**

To the appropriate representative of management or those charged with governance of ABC Company:

[The objective and scope of the audit]
You have requested that we audit the financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement 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.

[The responsibilities of the auditor]
We will conduct our audit in accordance with Philippine Standards on Auditing (PSAs). 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 judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. 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 PSAs.

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 concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

[The responsibilities of management and identification of the applicable financial reporting framework]
Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

a. For the preparation and fair presentation of the financial statements in accordance with Philippine 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 fraud or error; and
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 and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

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

[Other relevant information]

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report.]
The form and content of our report may need to be amended in the light of our audit findings.

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.

XYZ & Co.
Acknowledged and agreed on behalf of ABC Company by
(Signed)

....
Name and Title
Date

RECURRING AUDITS

On recurring audits, the auditor should consider whether:

1. The terms of the engagement to be revised
2. There is a need to remind the client of the existing terms of the engagement.

Factors that requires revised engagement terms, remind the entity of existing terms, and/or send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change of management, board of directors, or ownership.
- A significant change in ownership.
- A significant change in the nature or size of the client's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

ACCEPTANCE OF A CHANGE IN ENGAGEMENT

If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

If there is no reasonable justification, the auditor shall not agree to a change in the terms of the audit engagement.

Circumstances	Reasonably justifiable?	
1.	A change in circumstances affecting the need for the service	✓
2.	A misunderstanding as to the nature of an audit or related services originally requested	✓
3.	A restriction on the scope of the engagement, whether imposed by management or caused by circumstances	x
4.	If the change relates to information that is incorrect, incomplete, or otherwise unsatisfactory	x
5.	The auditor is unable to obtain sufficient appropriate audit evidence regarding assertions	**x**

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- **Withdraw from the audit engagement** where possible under applicable law or regulation, and
- **Determine whether there is any obligation** to report the circumstances to other parties.