

PKF PERSPECTIVES

AUDITING FINANCIAL STATEMENTS: THE PLANNING PROCESS

Your auditors are responsible for planning and performing your company's audit in order to obtain reasonable (although not absolute) assurance as to whether or not the financial statements are fairly presented and free of material misstatement due to error or fraud. This **PKF Perspectives** will cover the audit planning process in general for non-publicly traded companies and is intended to assist our clients in understanding the process and the part they play in it.

Planning begins with the engagement letter which basically documents the understanding of the assignment and the responsibility of the parties. In addition, the engagement letter generally indicates the period under audit, the services to be provided by the accounting firm, and the cooperation and documentation required to be furnished by the client.

Two Statements on Auditing Standards (SAS) issued by the Auditing Standards Board address the audit planning process:

- No. 78, ***Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55***, requires the auditors to obtain a clear understanding of the client's internal control, document their comprehension, evaluate the control risk, document assessment of the control risk, explore the viability of additional reductions in control risk, and determine the extent of substantive tests for financial statement assertions.

Internal control is a process designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations

When considering a client's internal control, there are five components that the auditor

should consider: (1) control environment ("tone at the top"); (2) risk assessment; (3) control activities; (4) information and communication; and (5) monitoring.

- No. 99, ***Consideration of Fraud in a Financial Statement Audit***, requires auditors to integrate fraud prevention and detection into the planning process. SAS No. 99 requires the audit team to discuss the potential for a material misstatement in the financial statements due to fraud before (or during) their information-gathering process. Many firms have developed "Risk Assessment Forms" to evaluate factors in the client's operational and financial environment that may affect the financial statements.

During the planning process, management should expect to discuss both of these standards with their outside auditors.

In order to obtain a better understanding of a company's activities and financial operations, the following tasks may be beneficial to the audit team in the planning phase:

- Analysis of the most current internal financial information
- Review of prior year's financial statements
- Review of previously-issued management letters
- Review of selected workpapers from the previous year's engagement that may provide ideas for possible areas of audit risk, e.g. internal control documentation, summary of audit differences, and summaries of key legal documents
- Review of client acceptance and continuance documentation

- Review of press releases, current marketing literature, and other information released by the entity
- Review of information about the industry

Materiality guidelines for testing should be determined in the planning stage. Materiality levels are judgmental and generally based upon a number of factors, including total assets, pre-tax profit, revenue and expenditures.

Potential computer assisted audit testing (CAATs) would also be identified during the planning phase.

Areas that have significant audit impact, such as new accounting standards, financial statement disclosure requirements, changes in legislation, etc. are integral to the audit planning phase.

Client management and/or the company's Board of Directors should be contacted in the planning stage to:

- determine if they have any concerns they wish to be addressed by the auditors
- determine if there have been any unusual transactions occurring since the last audit, such as:

recent or impending changes in industry or client's technology, products, services

acquisitions or disposals

new borrowings or equity transactions

changes in organization or management

regulatory matters

accounting or disclosure requirements

conversion of accounting systems

- provide documentation, such as minutes, detailed trial balances, supporting schedules, and other information and analyses
- agree to the timing of the audit fieldwork

Paraphrasing the Scottish poet Robert Burns, even the best laid plans of auditors are subject to change based on conditions encountered in the field. Therefore, your auditors may have to adjust their materiality levels, expand their scope, etc. depending on such conditions. Client management and the Audit Committee (or those with equivalent authority) should be kept informed.

The following **PKF Perspectives** issued earlier in the year may be of interest to you.

Audit Risk Update: Financial Reporting and Safeguarding Company Assets

Best Practices and Good Governance: Sarbanes-Oxley and the Privately-Held Company

Organizational Code of Conduct

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October 2005