Learning Objectives:
1. Understand purpose of audit planning
2. Make client acceptance and initial audit planning
3. Understand client’s business and its industry
4. Assess client’s business risk
5. Understand purpose of analytical procedures
6. Perform appropriate analytical procedures
7. Compute common financial ratios

Audit Planning

Preparation Question: Which GAAS standard talks about planning?

A. Reasons for planning:
- obtain sufficient appropriate evidence for the circumstances: industry, personnel, audit alerts, etc.
- keep audit cost reasonable
- avoid misunderstandings with the client
- evaluate acceptable audit risk: a measure of how willing the auditor is to accept that he/she may erroneously issue an unqualified report.

Preparation questions:
- If the auditor wants to completely certain about her/his decision about the opinion expressed on the financial statements then acceptable audit risk is ___________.
- If the auditor is will to be completely uncertain about his/her decision about the opinion on the financial statements then acceptable audit risk is ___________.
- evaluate inherent risk: a measure of the likelihood that there are material misstatements in an account balance.

Preparation Question: How does the potential for material misstatements relate to acceptable audit risk in decisions about evidence gathering? In other words, the more likely a client is to have misstatements in its financial statement and the less the acceptable audit risk the __________ higher/lower the amount of evidence gathered.

B. Accept client and perform initial planning
1. Client acceptance and continuance
   - SAS 84 requires that old and new auditors communicate.
     - Preparation Question: Who is responsible for initiating communication?
- Predecessor
  * Must have client permission to respond openly (client confidentiality)
  * Required to respond, even if to say no information will be provided.
- Communicate with other entities (attorneys, banks, other CPAs, etc.).
- Investigate backgrounds of management.
- Consider amount of risk for a failed audit.
- Previous conflicts on the report or fees.
- Evidence of lack of integrity of upper management.
- Pending lawsuit with client.
- Unpaid fees.

2. Identify client's reasons for audit
- SEC/SOX
- State regulation
- Other regulation
- Loan requirements
- Shareholders
- Plans for future (IPO)

In general, more users → more evidence

C. Obtain an understanding with the client

- Preparation Question: Is it required to document an understanding with the client?
- Preparation Question: Is an engagement letter required?

- Engagement letter (p. 214)
- Clarify responsibilities – services, timing, who does what, $.
- Limit legal risks
- Forms a contract with client

- Preparation Question: How does the engagement letter form a contract with the client?
- Preparation Question: For a publicly traded company, with whom does the auditor work out an understanding about the engagement?

D. Develop an overall strategy
1. Resource needs
   - nature of client
   - risk of significant misstatements
   - number of locations
   - internal control quality history
2. Staff the engagement
   - GAAS general standard #1
• continuity – advantages and disadvantages
• experience
• industry specialization
• outside specialists (SAS 73)

Goal to Identify: 1) potential problems/solutions and 2) types of evidence available

E. Understand the client’s business and industry (Figure 8-3 pg. 217)

Preparation Questions:
What is Client business risk?
List some examples of threats a company faces in achieving its goals?
Why does understanding a client business risks improve the quality of the audit?

1. Industry and external environment
   • Identify specific industry issues –
     * read relevant audit alerts (source: AICPA)
     * obtain knowledge of typical facts (ex. 7 years for restaurants to succeed)
     * identify major competitors in the industry (example source: Value Line)
     * read industry publications – ways of doing business, etc. (ABI Inform)
     * consider impact of general economic factors
     * understand technology issues
   • Identify inherent risks - very nature of what is done, such as handling cash
   • Know unique accounting principles/policies/practices
     * review permanent and last year’s current file.
     * read industry audit guides (source: AICPA).
     * read regulatory guides and other documents.

2. Client’s operations and processes
   • Identify major sources of revenue and financing
   • Determine where client is in the life-cycle of the business or main products
   • Identify major customers and suppliers
   • Identify joint ventures and strategic alliances
   • Identify related parties: any party where one party can influence the management or operating policies of the other (SAS 45); permanent file, affiliated companies, principal owner, other party that influences.
   • Tour facilities and operations
   • Evaluate use and quality of information technology
• Preparation Question: What are the GAAP disclosure requirements for related party transactions?

• Preparation Question: What type of related party transaction does SOX specifically prohibit?

3. Client’s management and governance
  • Determine management philosophy and operating style
  • Understand organizational structure, board of directors, audit committee
  • Read corporate charter and bylaws
  • Read code of ethics
  • Read minutes of meetings of board of directors

4. Client’s objectives and strategies
  • Understand commitment of and methodology for producing reliable financial reporting
  • Understand commitment to and design of a system to assure effective and efficient operations
  • Understand commitment to and design of the system to assure compliance with laws and regulations

5. Client’s measurement and performance
  • Identify key indicators used to evaluate progress toward objectives

Assess client business risk
1. Assess client business risk
   - Defined: The risk that the client will fail to achieve its objectives.
2. Evaluate management controls affecting business risk
3. Assess risk of material misstatements

In-class exercise:

Perform preliminary analytical procedures

A. Required for preliminary and final phases of the audit.
B. Purpose (Figure 8-6, p. 225)
   1. Understand the client's industry and business (Planning – primary)
   2. Assess going concern (Planning and completion – secondary)
   3. Indicate possible misstatements (Planning and completion – primary)
   4. Reduce detailed tests (testing – primary)
C. Types of comparisons – client's information with
   1. industry data
   2. prior period data.
   3. client determined expected results (budgets).
   4. auditor determined expected results.
   5. expected results, using nonfinancial data.

   Goal is to look for anomalies – balances that just don't seem right.

Preparation Questions:
1. Complete table on page 6 of the outline.
2. Compute the following for Alpha Company (pages 7 and 8 of the outline)
   - Common size percentages for the Income Statement for 2006 (page 7)
   - Amount & percentage of change between years for the Income Statement (page 7)
   - Percent of change in key Balance Sheet ratios (page 8)

V. Set Materiality and Acceptable Risk Levels (Chapter 9)

VI. Understand Internal Controls (Chapter 10)

VII. Develop an Overall Plan and Audit Program (Chapter 13)
**Preparation Question: Use of Ratio Analysis**

For each ratio listed below -

1. Indicate whether it is primarily
   - A. an indicator of financial failure
   - B. an indicator of potential misstatements
   - C. both

2. For each "A" answer, is it primarily
   - • Short-term (ST)
   - • Long-term (LT)

3. For each "B" and "C" answer, state the potential misstatement.

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Question 1 (A, B, or C)</th>
<th>Question 2 (for As only) ST or LT</th>
<th>Question 3 (for B and C only) Potential misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quick ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales commission / sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross margin %</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt / equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average days to collect receivables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense / average interest-bearing debt outstanding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory turnover</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit / tangible operating assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing repair and maintenance / manufacturing fixed assets</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# Common Size and Percentage Change

## For Years Ended

<table>
<thead>
<tr>
<th></th>
<th>2005 Balance</th>
<th>Common size</th>
<th>2006 Balance</th>
<th>Common size</th>
<th>Amount</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales (net)</td>
<td>9,000,000</td>
<td>100.00%</td>
<td>9,900,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>6,750,000</td>
<td>75.00%</td>
<td>7,200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross margin</td>
<td>2,250,000</td>
<td>25.00%</td>
<td>2,700,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General expenses</td>
<td>1,590,000</td>
<td>17.67%</td>
<td>1,734,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>300,000</td>
<td>3.33%</td>
<td>300,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses</td>
<td>360,000</td>
<td>4.00%</td>
<td>666,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>60,000</td>
<td>0.67%</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes</td>
<td>120,000</td>
<td>1.33%</td>
<td>256,000</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Net income</td>
<td>180,000</td>
<td>2.00%</td>
<td>370,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>600,000</td>
<td>14.78%</td>
<td>200,000</td>
<td>4.12%</td>
<td>(400,000)</td>
<td>(66.67)%</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>500,000</td>
<td>12.32%</td>
<td>900,000</td>
<td>18.56%</td>
<td>400,000</td>
<td>80.00%</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(40,000)</td>
<td>(0.99%)</td>
<td>(50,000)</td>
<td>(1.03%)</td>
<td>(10,000)</td>
<td>25.00%</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,500,000</td>
<td>36.95%</td>
<td>1,600,000</td>
<td>32.99%</td>
<td>100,000</td>
<td>6.67%</td>
</tr>
<tr>
<td>Total current assets</td>
<td>2,560,000</td>
<td>63.05%</td>
<td>2,650,000</td>
<td>54.63%</td>
<td>90,000</td>
<td>3.52%</td>
</tr>
<tr>
<td>Equipment</td>
<td>3,000,000</td>
<td>73.89%</td>
<td>4,000,000</td>
<td>82.47%</td>
<td>1,000,000</td>
<td>33.33%</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(1,500,000)</td>
<td>(36.95%)</td>
<td>(1,800,000)</td>
<td>(37.11%)</td>
<td>(300,000)</td>
<td>20.00%</td>
</tr>
<tr>
<td>Total assets</td>
<td>4,060,000</td>
<td>100.00%</td>
<td>4,850,000</td>
<td>100.00%</td>
<td>790,000</td>
<td>19.46%</td>
</tr>
<tr>
<td><strong>Liabilities and Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>500,000</td>
<td>12.32%</td>
<td>400,000</td>
<td>8.25%</td>
<td>(100,000)</td>
<td>(20.00)%</td>
</tr>
<tr>
<td>Bank loans</td>
<td>0</td>
<td>0.00%</td>
<td>750,000</td>
<td>15.46%</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>Accrued interest</td>
<td>60,000</td>
<td>1.48%</td>
<td>40,000</td>
<td>0.82%</td>
<td>(20,000)</td>
<td>(33.33)%</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>560,000</td>
<td>13.79%</td>
<td>1,190,000</td>
<td>24.53%</td>
<td>630,000</td>
<td>112.50%</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>600,000</td>
<td>14.78%</td>
<td>400,000</td>
<td>8.25%</td>
<td>(200,000)</td>
<td>(33.33)%</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>1,160,000</td>
<td>28.57%</td>
<td>1,590,000</td>
<td>32.78%</td>
<td>430,000</td>
<td>37.07%</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>2,000,000</td>
<td>49.26%</td>
<td>2,000,000</td>
<td>41.24%</td>
<td>0</td>
<td>0.00%</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>900,000</td>
<td>22.17%</td>
<td>1,260,000</td>
<td>25.98%</td>
<td>360,000</td>
<td>40.00%</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>4,060,000</td>
<td>100.00%</td>
<td>4,850,000</td>
<td>100.00%</td>
<td>790,000</td>
<td>19.46%</td>
</tr>
</tbody>
</table>

**Tick mark legend:**

@ Significant change from prior year. Warrants further investigation during audit.
### ALPHA COMPANY
### PRELIMINARY ANALYTICAL PROCEDURES
### SELECTED FINANCIAL RATIOS
### For Years Ended

<table>
<thead>
<tr>
<th>Balance Sheet Ratios</th>
<th>2005</th>
<th>2006</th>
<th>Percent Change</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current ratio</td>
<td>4.57</td>
<td>2.23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Days’ sales in receivables</td>
<td>18.40</td>
<td>30.91</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts ratio</td>
<td>0.0800</td>
<td>0.0556</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Days’ sales in inventory</td>
<td>80.00</td>
<td>80.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt/equity ratio</td>
<td>0.40</td>
<td>0.49</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Operations Ratio                      |      |      |                |                   |
| Receivable turnover                   | 19.57| 11.65| (40.47)        |                   |
| Inventory turnover                    | 4.50 | 4.50 | 0.00           |                   |
| Cost of goods sold/sales              | 75.00%| 72.73%| (3.03)        |                   |
| Gross margin percentage               | 25.00%| 27.27%| 9.09         |                   |
| Return on beginning equity            | 6.62%| 12.76%| 92.80       |                   |

| Financial Distress Ratios             |      |      |                |                   |
| Working capital/total assets          | 0.49 | 0.30 | (38.89)        |                   |
| Retained earnings/total assets       | 0.22 | 0.26 | 17.20          |                   |
| EBIT/Total assets                    | 0.09 | 0.14 | 54.87          |                   |
| Market value of equity/total debt    | 2.59 | 1.89 | (27.04)        |                   |
| Net sales/total assets               | 2.22 | 2.04 | (7.92)         |                   |
| Discriminant Z score                 | 4.96 | 4.35 | (12.32)        |                   |

**Tick mark legend:**
@ Significant change from prior year. Warrants further investigation during audit.