Audit Planning and Internal Control

Planning the Audit

- The **Engagement Letter** specifies services to be performed, the objectives of the audit, the responsibility of management and the auditor, and the limitations involved
- The **Audit Committee** of the firm to be audited:
  - Must be composed of three independent or outside directors who receive no compensation and have no affiliation with the company
  - Appoints, pays and oversees audits
  - Serves to deal with internal control weaknesses, makes audit adjustments, handles disagreements between the auditors and management, ensures the quality of accounting principles, and hunts down fraud and illegal acts
- If there is a **predecessor auditor**:
  - Before the engagement, new firm must ask mgmt. if the predecessor auditor can answer questions
  - Questions about disagreements and reasons for change reveal management integrity
- An **Audit Program** involves:
  - Understanding, flowcharting, and testing internal controls
  - Performing substantive tests for major balance sheet accounts to detect misstatements
  - Progression: Statements, management assertions, audit objectives, audit procedures, audit evidence, audit report.

Internal Control

- The stronger the internal control, the more it can be relied on.
  - If an auditor relies on the internal controls, internal controls will be tested vigorously
- Internal control processes provide reasonable assurance that misstatements will be prevented or detected
- Benefits should exceed cost
- Composed of:
  - Control environment, Risk assessment & Information system
  - Control activities must be monitored
    - Performance reviews, info processing, physical controls, and segregation of duties
- Prevent loss of cash or inventory
  - **Irregularities** involve fraud (intentional misreporting or misappropriation of assets)
  - **Errors** involve mistakes (unintentional misstatement)
- Accurate records of transactions and balances; transaction cycles include:
  - **Revenue** (sales and collections)
    - Orders → Approve credit → Ship goods → Prepare invoice → Record revenue and accounts receivable → Book receipts
  - **Acquisition** (purchase and disbursements)
    - Purchase order for inventory, assets and services → Inspect goods received → Prepare receiving reports → Record payable to vendors → Authorize payment → Make disbursement
  - **Conversion** (Production)
    - Store material → Production costs to inventory → CGS
  - **Payroll**
    - Hire, terminate, determine pay rate, timekeeping, compute gross pay, taxes, withholding
    - Keep records & Distribute checks
  - **Financing**
    - Loans, leases, bonds, stock: negotiate, contract, register
  - **Investing**
    - Acquiring and selling fixed assets and securities
    - Recording depreciation, amortization, interest, dividends
- **Separate functions**: Authorization, recordkeeping, custodianship