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ACC51113 – INTEGRATED REVIEW IN AUDITING AND ASSURANCE

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MODULE 6
PLANNING AN AUDIT OF FINANCIAL STATEMENTS

PSA 300 Redrafted "Planning an Audit of Financial Statements" states that *the auditor should plan the audit so that the engagement will be performed in an effective manner.*

- a. It involves establishing the overall for the engagement and developing an audit plan strategy and a detailed approach for the expected nature, timing and extent of the audit.
 - b. It involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.
1. Adequate planning of the audit work accomplished among others the following:
 - a. It ensures that appropriate attention is devoted to important areas of the audit
 - b. It enables the auditor to identify potential problems and resolve them on a timely basis
 - c. It helps to ensure that the engagement is properly organized and managed in order to be performed in an effective and efficient manner.
 - d. It assists in the proper assignments of the engagement team members.
 - e. It facilitates the direction and supervision of engagement team members and review of their work.
 - f. It assists in coordination of work done by auditors of components and experts.
 2. The extent of planning will vary according to
 - a. Size of the entity
 - b. The complexity of the audit
 - c. Auditor's experience with the entity
 - d. Changes in circumstances that occur during the audit engagement.
 3. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
 4. In planning an audit the auditor considers the following:
 - a. Discussion among engagement team members
 - b. Analytical procedures to be applied as risk assessment procedures
 - c. Obtaining of a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework
 - d. Determination of materiality
 - e. Involvement of experts
 - f. Determination of assessment procedures prior to identifying and assessing the risks of material misstatement and performing further audit procedures at the assertion level for classes of transactions, account balances, and disclosures that are responsive to those risks.

Preliminary Engagement Activities

1. Perform procedures regarding the continuance of the client relationship and the specific audit engagement.
2. Evaluate compliance with ethical requirements, including independence.
3. Establish an understanding of the terms of the engagement.

The purpose of preliminary engagement activities is to help ensure that the auditor has considered any events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level.

It also helps to ensure that the auditor plans an audit engagement for which

1. The auditor maintains the necessary independence and ability to perform the engagement.
2. There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
3. There is no misunderstanding with the client as to the terms of the engagement.

Planning Activities

1. The auditor should establish the overall audit strategy for the audit.
Overall audit strategy sets the scope, timing and direction of the audit and guides the development of the more detailed audit plan.

The establishment of overall audit strategy involves:

- a. Determining the characteristics of the engagement that define its scope, such as financial reporting framework used industry-specific reporting requirements and the locations of the components of the entity.
 - b. Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as the deadlines for interim and final reporting, and key dates for the expected communications with management and those charged with governance.
 - c. Considering the important factors that will determine the focus of the engagement team's efforts.
2. The auditor should develop an audit plan for the audit in order to reduce the audit risk to an acceptably low level.
Audit plan includes the following:
 - a. A description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
 - b. A description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balances and disclosures.
 - c. Such other procedures required to be carried out for the engagements to comply with PSAs.
 3. The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit.
 4. The auditor should plan the nature, timing and extent of the direction and supervision of engagement team members and review of their work.
 5. The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.

Audit Program

An *audit program* is a set of audit procedures specifically designed for each audit. The program which includes both substantive tests and tests of controls will enable the auditor to express an opinion on the financial statements taken as a whole.

The auditor should develop and document an audit program setting out the nature, timing, and extent of planned audit procedures required to implement the overall audit plan. The audit program serves as a set of instructions to assistants involved in the audit and as a means to control and record the proper execution of the work. The audit program may also contain the audit objectives in which hours are budgeted for the various audit areas or procedures.

On initial engagements, the audit program typically will develop in three stages:

1. The broad phases of the program can be outlined at the time of the engagement.
2. Other details of the program can be identified after the review of internal control structure and accounting procedures has begun
3. Procedures on specific phases of the audit can be further challenged and revised as the work progresses.

On recurring engagements, the program for the preceding audit should be studied before preparing the program for the current audit. The program of the current audit should reflect modifications or are required by the experience gained in the business, internal control or accounting methods of the client.

"The overall audit plan and the audit program should be revised as necessary during the course of the audit. Planning is continuous throughout the engagement because of changes in conditions or unexpected results of audit procedures. The reasons for significant changes would be recorded."

An audit program that is properly prepared and used provides:

1. Evidence of proper planning of the work and allows a review of the proposed scope of the audit. The program gives the partner, manager and other members of the audit team an opportunity to review the proposed scope of the audit *before* the work performed, when there is still time to modify the proposed audit procedures.
2. Guidance to less experienced staff members.
3. Evidence of work performed.
4. A means of controlling the time spent on an audit.
5. Evidence of the consideration of control risk in designing the proposed audit procedures.

Time Budget

A *time budget* is an estimate of the total hours an audit is expected to take. It is based on the information obtained in the first major step in the audit, that is, obtaining an understanding of the client.

Steps in the Audit Planning

I. Obtaining an understanding of the entity and its environment

According to PSA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," in performing an audit of financial statements, the auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practice that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.

The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. The level of knowledge required by the auditor would, however, ordinarily be less than that possessed by management.

PSA 315 Redrafted outlines the key steps in understanding the entity and its environment:

- a. Industry, regulatory and other external factors, including the applicable financial reporting framework
- b. Nature of the entity, including its selection and application of accounting policies.
- c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
- d. Measurement and review of the entity's financial performance.
- e. Internal control.

a. Industry, regulatory and other external factors

1. Industry conditions

Understanding industry conditions include understanding the market for a client's products, the competition, the entity's and competitor's capacity relative to market conditions and price competition.

2. Regulatory environment

The regulatory environment can have direct economic consequences and affect accounting and disclosure requirements. PSA 250 "Consideration of Laws and Regulations in an Audit of a Financial Report" states that the auditor must obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and the entity's level of compliance.

3. Economy-wide factors

The general economy and its effect on the entity's business should also be considered by the auditor. This includes the general level of economic activity, interest rates and the availability of financing, and the level of inflation.

b. Nature of the entity, including its selection and application of accounting policies

1. Business operations

Knowledge of the entity's business operations includes understanding such matters as the entity's

- a. Method of obtaining revenues
- b. Products or services and markets
- c. Conduct of operations
- d. Location of production facilities, warehouses and offices
- e. Employment
- f. Transactions with related parties.

Knowledge of the entity's business operations may influence the selection and application of accounting policies. Auditors use the knowledge of the entity's operations to identify significant inherent risks. Another important aspect of understanding the business operations involves obtaining knowledge of related party transactions. Related party transactions are transactions between a company and its management, principal owners, their immediate family members, and/or affiliated companies. These transactions represent high inherent risks because they may not have the economic substance of an arm's-length transaction between two independent parties. PSA 550 "Related Parties" describe the important procedures that should be performed in planning an audit.

2. Investments

Knowledge of the entity's investing activities includes understanding the entity's

- a. Capital investment activities, including investments in plant and equipment and technology and any recent or planned changes.
- b. Acquisitions, mergers or disposals of plant activities
- c. Investments and dispositions of securities and loans
- d. Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

3. Financing

Knowledge of the entity's financing activities includes understanding the entity's

- a. Debt structure, including covenants, restrictions, guarantees and off-balance sheet financing arrangements.
- b. Group structure – major subsidiaries and associated entities, including consolidated and non-consolidated structures.
- c. Leasing of property, plant and equipment for use in the business.
- d. Beneficial owners.
- e. Use of derivative financial instruments.

4. Financial Reporting

Knowledge of the entity's financial reporting activities includes understanding such matters the entity's

- a. Accounting principles and industry-specific practices
- b. Revenue recognition practices
- c. Accounting for fair-value
- d. Inventories
- e. Industry-specific significant accounts and transaction classes
- f. Accounting for unusual or complex transactions, including those in controversial or emerging areas, such as accounting for share-based transactions.
- g. Financial statement presentation and disclosures.

c. The entity's objectives, strategies and related business risks

According to PSA 315 Redrafted, the auditor shall obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial report. These terms are defined as follows:

Entity's objectives – are the overall plans for the entity as defined by those charged with governance and management.

Entity's strategies – are the operational approaches by which management intends to achieve the objectives.

Business risks – result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.

Matters that auditor may consider include:

- a. Industry developments
- b. New products or services
- c. Expansion of the business
- d. Current and prospective financing requirements

A "business risk approach" allows the auditor to identify the threats that the organization faces in attempting to achieve its goals and the extent to which these give rise to audit risks. It also recognizes that most business risks will eventually have financial consequences and therefore, have an effect on the financial statements. Sometimes referred to "top-down approach", everything is considered at the highest level when reviewing business risk and then worked down to the lowest level where a material risk might be possible.

Business risks can be categorized as follows:

1. Financial risks – these are risks arising from the company’s financial activities or the financial consequences of operations.
2. Operational risks – these are risks arising from the operations of the business.
3. Compliance risk – these are risks arising from noncompliance with laws, regulations, policies, procedures and contracts.

d. Measurement and review of the entity’s financial performance

Matters that auditor may consider include

- a. Key ratios and operating statistics
- b. Key performance indicators
- c. Employee performance measures and incentive compensation plans
- d. Industry trends
- e. The use of forecasts, budgets and variance analysis
- f. Analyst reports and credit rating reports.

I. Performing analytical procedures

PSA 520 Redrafted “Analytical Procedures” requires that auditor apply analytical procedures in the planning stage of the audit to obtain a more detailed understanding and to identify areas of potential risk. Such procedures are performed during the planning phase to (1) enhance the understanding of the entity’s business and (2) to identify unexpected fluctuations and unusual relationships.

Analytical procedures involve a study and comparison of relationships among data to identify expected or unexpected fluctuations and other unusual items. The common types of analytical procedures involve a comparison of the entity’s financial information with

- a. Comparable information for a previous period or periods.
- b. Expected results such as budgets or forecasts.
- c. Industry averages.

Analytical procedures also include the study of relationships

- a. Among elements within the financial statements, such as a study of gross margin percentages.
- b. Between financial information and relevant non-financial information, such as the study of payroll costs for a number of employees.

Important Characteristics of Analytical Procedures at Three Audit Stages

Stage of the Audit	Required	Purpose
1. Planning	Yes	To assist in planning the nature, timing and extent of other auditing procedures.
2. Substantive Testing	No	To obtain evidential matter about particular assertions related to account balances or classes of transactions.
3. Overall Review	Yes	To assist in assessing the conclusions reached and in the evaluation of overall financial statement presentation.

II. Consideration of fraud in audit planning

The auditor is required to consider the risks of material misstatements in the financial statements due to fraud. According to PSA 240 Redrafted “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, it requires that “when obtaining an understanding of the entity and its environment, including its internal control, the auditor shall consider whether the information obtained indicates that one or more fraud risk factors are present.”

In making the assessment of whether fraud risk factors are present, the auditor should understand the three conditions that are generally present when fraud occurs. These are known as the “**fraud triangle**”.

1. Incentives/Pressures
2. Opportunities
3. Attitudes/Rationalizations

Risk Assessment Procedures are procedures used to obtain an understanding of the entity and its environment sufficient to assess the risks and consider these risks in designing the audit plan.

These include the following:

- 1) Inquiries of management.
- 2) Analytical procedures.
- 3) Observation and inspection.
