

**CONSIDERATIONS ON THE PLANNING OF THE FINANCIAL AUDIT MISSION**

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**Abstract:** In order to exercise efficiently the financial audit it is required to adequately plan it, for each individual mission. This document synthesizes the essential aspects which must be taken into account by the auditors and divides them into groups, according to the following paths of action: obtaining a detailed knowledge of the entity audited; estimating an acceptable level of the audit risk; understanding the internal control system of the entity; determining rigorously of the terms of the mission.

**Key words:** audit, planning, particularities, risk, engagement.

Being an activity which aims at analyzing the results of human activities, the financial audit is done with its own methodology, meaning a number of activities, done in stages, with the role of contributing to the achievement of the final goal, that of obtaining the necessary information to express an opinion as to the annual financial statements.

In order to achieve this goal, adequate planning and the definition of an auditing model to better suit the purpose of the mission has significant implications on the whole process, as on this stage depends the positive result of the mission. In order to plan accurately the mission, the auditor must start from two essential points, meaning: the determined audit model must allow him to gather adequate and sufficient evidence, and obtaining them at reasonable cost.

That is why, in the diligence necessary to plan the mission, we must take into consideration many aspects, whose contents and implications on the other phases of the auditing process we will present below.

The central element of the planning stage is, in our opinion, obtaining detailed knowledge of the organization being audited, which will make it easier to draft the general auditing plan and a program to better suit the given circumstances.

In such conditions it is important that the auditor obtain a good knowledge of the specific of activity and of the field in which operates the entity being audited, at least for the following reasons:

- understanding the particularities of organizing and management of accountancy, as it is a well known fact that in many areas of activity, such as constructions, railways, chemical industry, and so on, there are specific operations and events, which demand adequate accountancy solutions, thus influencing the presentations in the financial situation reports drafted by these entities;
- identifying the specific risks of the field, which influence both the way in which the audit risk is estimated at an acceptable level, and the decision about accepting the mission. In this context we must state that the field risk is considered by very many specialists as being one of the most important ones. In this way we can

justify the current tendency, registered at international level, in what reorganizing the activities of the audit firms is concerned, by concentrating only on certain fields of activity, by giving up a series of existent clients or by refusing the potential ones. By analyzing the context specific to the Romanian economy we can say that this factor has a important significance due to the profound restructuring which are currently taking place, along with the integration in the European Union;

- identifying and assessing the inherent risks, because they can be divided according to the specificities of the field of activity;
- knowing the conditions of the market, in the sense that we follow the demand for products, the position of the competition, their short and middle term perspectives, the influences of the technological development, and so on.

Among the important preoccupations of the auditor in the planning stage is estimating the acceptable level of the audit risk, as well as of the inherent risk, because the values of these two categories of risks have implications in what the future actions which will be undertaken are concerned.

Thus, in the situation when the auditor assess that for the entity being audited it is more appropriate to have a low level in what the acceptable audit risk is concerned, which expresses the degree in which it is willing to accept significant erroneous presentations in the financial situation reports, a number of measures are in order, among which we name:

- collecting a larger quantity of audit evidence, to ensure the increase of the auditor's certainty that there aren't any significant erroneous presentations to affect the contents of the reports on the financial situation. Because this risk concerns the ensemble of the audit process, the measure we have presented above leads inevitably to an increase of the audit costs and an extension of the period of time in which it is done. We thus feel that when deciding upon low levels of this category of risks, the auditor must have the professional ability of determining an optimal level in what the quantity of elements used as evidence which must be gathered, so that it doesn't affect the performance of the process as a whole;

- choosing people with a high level of experience and professional training in the team doing the audit;

- rigorously applying the procedures about the verification of the way in which the audit is done, in order to offer the guarantee that the work done is of an acceptable standard. The literature on the matter recommends, from this point of view, several options, among which using verifications operated by employees of the audit firm who aren't taking part in that particular contract is a very frequent practice.

A similar approach, from the point of view of the actions which will be undertaken, is found also in the case of the high inherent risk, as an estimate of the probability that an significant erroneous presentation exists in the case of an account, before taking action in what the assessment of the internal control system of the entity is concerned. The auditor's decision regarding the increase in the quantity of evidence is easier in this situation, because the inherent risk doesn't regard the ensemble of the audit process, but only some individual elements, so that the estimated costs related to it do not undergo major increases.

However we must mention the fact that the specialists of the field are debating on taking into consideration, in the planning stage, of the risk that the audit company or the individual auditor, as the case may be, suffer the consequences in the case of the client's bankruptcy, despite the fact that the audit done was of the finest quality. The

supporters of this risk say that an increase in the quantity of audit evidence is justified because the auditor will be in a better position if it may prove necessary to defend the results of his audit in the court of law, as it is a well-known fact that the general tendency of the users of the reports on the financial situation in the case of an economical failure is to sue the auditors, no matter what the quality of their work has been.

Understanding the internal control system of the entity is another condition for an adequate planning of the audit mission, which includes, essentially, obtaining information regarding the way the devices of this control are projected, as well the way in which they are applied. The entity's internal control system is made up of several components, but during this stage the auditor is preoccupied with understanding those mechanisms which are relevant for the assertions on the reports on the financial situations. That is why special attention will be given to the internal accountancy system of the entity, so that the main categories of operations realized can be identified and understood, initiating and reflecting them in the documents justifying the audit, registering them in the accountancy department, as well as presenting them in the reports on the financial statements. In order to fulfill these demands the auditor must see if the entity's management applied an adequate system, which must have as objectives the following aspects:

- elaborating the reports on the financial situation at the dates decide upon and in compliance with the relevant accountancy references;
- elaborating the periodical accountancy reports in compliance with the laws of the country, emitted by the authorized organisms;
- doing accurately the compulsory accountancy books;
- registering the operations in the books only base don documents to justify them;
- facilitating the annual inventory.

Because, frequently, the audit for one entity is done by the same auditor every year, knowing and understanding the internal control system is reduced to updating the information obtained in the previous years, because, normally, these systems aren't subjected to radical changes in short periods of time.

No matter if it is a first time commitment or a recurring mission, the main procedures studied by the literature of the field in order to understand the accountancy and the internal control systems, can be grouped as follows:

- having discussions with the entity's personnel at managerial, supervisor or operative level;
- analyzing all of the entity's documents and evidences, to offer a supplementary confirmation of the fact that the control policies and mechanism have been applied;
- observing the entity's activities and operations, which implies observing the personnel during the drafting of the documents and evidences or while doing controls, focusing their attention on the operations specific to the accountancy department.

Furthermore, the understanding of the conception and functioning of the internal accountancy and control system of the entity is an aspect which concerns the entire audit process, not only the planning stage. To support this statement we can quote the opinion of the famous specialist of the field, Ioan Oprean, according to whom „*This understanding is necessary to the auditor both in the planning stage of the commitment (mission), as well as in the collecting and evaluating audit evidence. By knowing the*

*way in which the entity is organized and the way in which the accountancy and the internal control systems function, the auditor used professional judge in order to assess the audit risks and to decide the audit procedures necessary for reducing the audit risk at an acceptable level.”<sup>17</sup>.*

A significant aspect in close relation to the planning activity is deciding the terms under which the audit mission will be done. In order to do this part of the stages presented above can be done based on a verbal commitment with the client, but, if the auditor decides to accept the mission, it is compulsory to draft a document to determine accurately the terms of the commitment. This is stated in the audit standards, which stipulate that „*the auditor and the client must agree on the terms of the commitment*”<sup>18</sup>, and the actual way in which these demands are done is *The letter of Commitment* or a *Contract*, in which a series of elements are decided upon, based on the circumstances of the mission.

Registering the terms of the commitment in such a document accepted by both parties is important in order to avoid any disagreement about the audit process.

Although the form and the contents of the acceptance letter of the mission is so different from one auditor to another, as well as from one client to another, we can say that it can be structured as follows:

- confirming the acceptance of the mission;
- describing the terms and the objectives of the mission;
- stating the client’s responsibilities;
- mentioning the mission’s calendar, including deciding on the fee;
- mentioning the viability of the document.

*Confirming the acceptance of the mission* is included in the contents of the letter, by a standard formula; the audit standards recommend, in this case, the expression „*we are thrilled to confirm the acceptance of this commitment by the contents of this letter.*”<sup>19</sup>

*The description of the terms and objectives of the mission* does a brief presentation of some elements necessary for the realization of the mission according to standards.

It shall thus be stated that it is necessary to have meetings with the managers of different departments, even if they, because of the nature of their activity, do not participate directly to the elaboration of the reports of financial situations, details which will be presented in a document called *Confirmation Letter*.

On the other hand, the auditors request to take part at the inventory of the corporal immobilizations must be mentioned. For this it must be requested that the procedures elaborated by the entity be made available, as well as the calendar of the said activities.

At the same time, it must be taken into account that the audit process implies the random examination of the elements supporting the presentations in the financial situation report, and, moreover, it is subjected to inherent limitations because of the internal control and accountancy system of the entity, aspects which cannot completely eliminate the risk than significant anomalies go undetected.

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<sup>17</sup> Ioan Oprean, *Financial Audit and Control*, Intelcredo Publishing House, Deva, 2002.

<sup>18</sup> Audit Standard nr.210 *Terms of the audit commitments*.

<sup>19</sup> Audit Standard nr.210 *Terms of the audit commitments*.

Another significant element for the contents of this section of the acceptance letter is to mention the fact that the audit will be planned and realized so that to offer reasonable insurance that the financial situation reports are free of any significant anomalies.

If the auditor thinks that he will use the confirmation procedure, we must say that the confirmation letters will be drafted by the client, for the auditor, and examining the responses received must be done by the auditor.

*Stating the client's responsibilities* is the section of the letter where it is stated that ensuring the management and organization of the accountancy and of the internal control system, defining and applying the policies of closing down the accounts, as well as ensuring all of the measures necessary for an accurate protection of the actives is the job of the entity's management, which, at the same time, prepares the financial situation reports and all of the other information necessary to the auditor.

*The mission's calendar and deciding the fee* contain a brief presentation of the main operations necessary for the audit, in relation with the period of time in which they will be done, among which we mention:

- initial discussions with the entity's employees to get a detailed knowledge of its characteristics;
- planning the audit mission per-say;
- doing control tests if the auditor has decided the preliminary estimation of the control risk at a lower level;
- assisting at the inventory operations mentioned above;
- obtaining a final control balance, to include solutions for the possible differences found during the inventory;
- doing detailed tests on the balances of the accounts;
- obtaining the final financial situation reports;
- participating at the Board Meeting which approves the financial statements;
- drafting the audit report.

In what the documentation of the actions mentioned above is concerned, it is not compulsory to specify them in the mission letter. Any way, the Romanian Chamber of Financial Auditors recommends registering them on different work sheets. In the case of our action, we have included them in this section of the mission letter, in order to show the points of view of the Romanian specialists in the field, such as professor Ioan Oprean<sup>20</sup>.

At the same time, this section of the letter speaks of the fee for the realization of the mission, the way in which this aspect is presented being different according to the given circumstances (if the mission is done by a team, we can mention the fee for one hour of work, for each member). There will also be references to expenses, such as transport, boarding, and so on, which will be covered as they occur.

Stating the *validity* of the mission letter is one of its non-compulsory components. Naturally, for every audit mission it is necessary to draft such a document, but in the case of successive audit missions, if there have been no substantial modifications from one year to another, a further clause can be introduced about the validity. In this sense the audit standards recommend the following formula: *this letter*

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<sup>20</sup> Ioan Oprean, Financial Audit and Control, Intelcredo Publishing House, Deva, 2002, page 169.

*shall remain valid for the following years, except for the cases when it shall be declared null or replaced.*<sup>21</sup>

The Romanian Chamber of Financial Auditors advises that the terms of the commitment be periodically revised. We must also say that when analyzing the necessity of elaborating a new commitment letter, it is necessary to give a greater attention to the changes at the management level, the modifications of the rights of property, as well as the modifications of the legal and professional standards.<sup>22</sup>

The elements considered relevant for the contents of the commitment letter are different according to the practices of the different economical environments.

Thus, the American literature of the field states that the document mentioned above must include distinctly at least the following elements: the confirmation of the commitment for that particular financial exercise, a declaration of responsibility in the case of errors and fraud, payment commitments, as well as other terms of the mission.<sup>23</sup>

In the case of the American specialists we can notice the high degree of importance given to the confidentiality of the information obtained during the auditing process. In this respect there are opinions<sup>24</sup> supporting the inclusion, in the mission letter, of a declaration saying that any lacks of the accounting and internal control systems discovered during the auditing process be made known to the management of the entity and not be made public to third parties, except for the legal or professional laws preventing from doing so.

In the British environment it is believed that the acceptance letter must contain, among other elements, „*a synthesis of the responsibilities of the management and of the auditors*”.<sup>25</sup>

A distinct issue concerning the analysis of the mission letters is represented by the fact that they are also drafted for other services offered by the auditors. In these cases most of the specialists recommend drafting a distinct document, showing the characteristics of those actions. The Romanian audit standards say that for fiscal, accountancy or management consultancy services „*it is adequate to draft separate letters*”.<sup>26</sup>

A rigorous analysis of the mission letters must be done in the case of the audit of the components, when there is the possibility that the auditor of the mother-entity be, at the same time, the auditor of one of its components.

The audit standards recommend to fundament the decision about the adequate character of sensing a separate letter in these circumstances, by taking into consideration the following factors:<sup>27</sup>

- who appoints the auditor of the components;
- the need to draft separate audit reports for every component;

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<sup>21</sup> Audit Standard nr.210 *Terms of the audit commitments*.

<sup>22</sup> Romanian Chamber of Auditors, Minimum Rules of Audit, Economical Publishing House, Bucharest, 2001, page 39.

<sup>23</sup> D.H. Taylor, G.W. Glenzen, Auditing: integrated concepts and procedures, John Wiley & Sons Publishing House, 4<sup>th</sup> edition, 1988, page187.

<sup>24</sup> G.W. Cossierat, Modern auditing, John Wiley & Sons Publishing House, New York, SUA, 2000, page176.

<sup>25</sup> ACCA (The Association of Chartered Certified Accountants), Auditing Handbook 1998/99, 1998, SAS 140.4.

<sup>26</sup> Audit Standard nr.210 *Terms of the audit commitments*.

<sup>27</sup> Audit Standard nr.210 *Terms of the audit commitments*.

- the distribution of the audit work between him and other auditors;
- the level of control of the mother-entity on the components;
- the degree of independence of the management of the components;
- the existence of different legal requirements.

On the other hand, the specific of the planning stage, meaning that it can be partial done based on only a verbal agreement with the client, can lead to two distinct situations, when the auditor is asked to change his engagement: before signing the mission letter or after.

No matter in which moment he is required to do the change, the main elements leading to it can be as follows:

- a change of the circumstances affecting the need for the service;
- not understanding the nature of the audit;
- limiting the area of action of the commitment, because of the management or because of other circumstances.

Changing the terms of the commitment is, essentially, changing an audit commitment in one of linked services. In order to do so the auditor must consider the legal obligations of the change, as well as how reasonable is the reason for this request. If there is a reasonable justification for the change, the commitment will be done in compliance with its new terms, and at the end of it there will be an accurate report.

From the point of view of the audit standards, *reasonable justification* which fundamentals the decision mentioned above is grounded only in the case in which the circumstances affecting the entity have been changed, or not understanding the nature of the service demanded in the first place.

If the request for change of the commitment is linked to incorrect or incomplete information, or the area of application of the commitment is limited because of the management, the auditor will feel that there is no reasonable justification, and so, that he must back-out of the commitment.

Furthermore, we must remind the fact that the planning and programming of the audit activity is a continuous process during all the duration of the mission, due to the change of the initial conditions or to obtaining new information by applying the audit procedures. In this context, the audit standards state that „*the general audit plan and the audit program must be revised whenever necessary during the course of the audit*”.<sup>28</sup>

We also mention the fact that the planning stage is longer from the point of view of the diligences which must be done by the auditor, including the preliminary assessment of the significance level and of the control risk.

As we can see from this briefing, planning the financial audit mission is an action which must be done with increased care and attention on behalf of the auditor, so that the premises of the fulfillment of the assumed objectives are ensured.

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<sup>28</sup> Audit Standard nr.300 *Planning*.

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