

What is Audit Planning and Risk Assessment?

Worksheet

Audit planning is the process of understanding the entity, assessing the risks of material misstatement, setting materiality, and designing audit procedures that respond directly to the risks identified - required under ISA 300 and ISA 315.

Questions

1. What is the primary purpose of audit planning?

- A) To finalize the audit opinion
- B) To identify areas of higher risk and design an efficient response
- C) To prepare the client's tax return
- D) To replace internal controls

2. Pre-tax income is \$500,000 and the firm applies 4% materiality. What is overall materiality?

- A) \$2,000
- B) \$20,000
- C) \$200,000
- D) \$50,000

3. Risk of material misstatement is a combination of which two risks?

- A) Detection risk and business risk
- B) Inherent risk and control risk
- C) Sampling risk and fraud risk
- D) Audit risk and detection risk

4. Which of these is performed FIRST in the audit planning process?

- A) Designing substantive tests of detail
- B) Understanding the entity and its environment
- C) Issuing the audit opinion
- D) Sending the management representation letter

5. A company has pre-tax income of \$2,000,000. The auditor uses 5% of pre-tax income for materiality. What is overall materiality?

6. During risk assessment, the auditor learns the client just implemented a new ERP system with no prior audit history. How does this affect planning?

7. Revenue is \$8,000,000 and total assets are \$15,000,000. The firm's policy uses 1% of the larger benchmark (total assets) since the company is asset-heavy. What is materiality?

8. Define: What is the main goal of audit planning?

9. Define: What two components combine into the risk of material misstatement?

10. Define: What is materiality in an audit?

Answer Key

1. B) To identify areas of higher risk and design an efficient response - Planning focuses audit effort on the areas most likely to contain material misstatement.
2. B) $\$20,000 - \$500,000 \times 4\% = \$20,000$.
3. B) Inherent risk and control risk - Inherent risk control risk = risk of material misstatement, assessed before considering audit procedures.
4. B) Understanding the entity and its environment - You must understand the business before you can assess risk or design procedures.
5. Materiality = Benchmark Percentage Materiality = $\$2,000,000 \times 5\% = \$100,000$
6. New, untested IT system higher inherent and control risk at the assertion level Auditor lowers detection risk by planning more extensive substantive testing around system-generated balances
7. Benchmark = Total assets = $\$15,000,000$ (larger, and asset-heavy per policy) Materiality = $\$15,000,000 \times 1\% = \$150,000$
8. To understand the entity and design an audit strategy that focuses effort where the risk of material misstatement is highest.
9. Inherent risk and control risk.
10. The threshold above which a misstatement could reasonably influence the decisions of financial statement users.

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