Audit Quality Assurance Workshop
Mt. Kenya Branch

Theme: Embracing International Auditing Standards in Carrying Out Audit Engagements

Audit planning, Strategy and Materiality

Thursday 23rd March 2017

Contents:

- Scope
- Role & Timing of planning
- Involvement of key engagement team members
- Planning activities
- Documentation
- Materiality
- Examples

1. SCOPE

- ISA.300. This International Standard on Auditing (ISA) deals with the auditor's responsibility to plan an audit of financial statements. This ISA is written in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified

2. Role & Timing of planning

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan:

Benefits of adequate planning include:

- The auditor is able to devote appropriate attention to important areas of the audit.
- The auditor can identify and resolve potential problems on a timely basis.
- The auditor can properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

2. Role & Timing of planning (Cont..)

Benefits of planning Cont……

- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts

2. Role & Timing of planning (Cont..)

The nature and extent of planning activities is influenced by:

I. Size and complexity of the entity,
II. The key engagement team members' previous experience with the entity,
III. Changes in circumstances that occur during the audit engagement

2. Role & Timing of planning (Cont..)

Planning includes the need to consider, other matters such as:

i. The analytical procedures to be applied as risk assessment procedures.
ii. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
iii. The determination of materiality.
iv. The involvement of experts.
v. The performance of other risk assessment procedures.

3. Involvement of Key Engagement Team Members

The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Team planning event)

4. Preliminary Engagement Activities

The auditor shall undertake the following activities at the beginning of the current audit engagement:

- Performing procedures required by ISA 220 regarding the **continuance of the client relationship** and the specific audit engagement;
- Evaluating **compliance with relevant ethical requirements**, including independence, in accordance with ISA 220;2 and
- Establishing an understanding of the **terms of the engagement**, as required by ISA 210.3

5. Planning Activities

The auditor shall establish an overall audit strategy that sets **the scope, timing and direction of the audit**, and that guides the development of the audit plan by:

- Identifying the characteristics of the engagement that define its scope;
- Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

5. Planning Activities. (Cont.)

- Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

5. Planning Activities. (Cont.)

The auditor shall develop an audit plan that shall include a description of:

- The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315
- The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.5
- Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs.
- The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.
- The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work

6. Documentation

The auditor shall include in the audit documentation:

- The overall audit strategy;
- The audit plan; and
- Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

7. Additional Considerations (Initial Audits)

The auditor shall undertake the following activities prior to starting an initial audit:

a) Performing procedures required by ISA 220 regarding the acceptance of the client relationship and the specific audit engagement;

b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

8. Key considerations when preparing audit strategy/plan

- Financial reporting framework
- Industry specific reporting requirements
- Nature of control between the parent & its components – consolidation
- Extent to which components are audited by other auditors
- Nature of business segments to be audited
- Reporting currency to be used including any need for translation
- Whether there is an internal audit function and how their work can be used
- Use of service organisations and key processes handled
- Expected extent of use of prior period evidence
- Effect of technology on audit procedures and use of CAATs

9. ISA 320. MATERIALITY

Scope:

This International Standard on Auditing (ISA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

9. ISA 320. MATERIALITY. Cont..

Materiality definitions in the context of Financial Statements Audit:

- Misstatements, including omissions, are considered to be material if they, **individually or in the aggregate, could reasonably be expected to influence the economic decisions** of users taken on the basis of the financial statements;

- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered

9. ISA 320. MATERIALITY. Cont..

Key assumptions when setting materiality:

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.

The auditor can reasonably assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

10. Performance Materiality:

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

11. Determining Materiality and Performance Materiality

Requirements:

i. When establishing the overall audit strategy, the auditor shall determine **materiality for the financial statements as a whole.**

ii. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

iii. The auditor shall determine performance materiality **for purposes of assessing the risks of material misstatement** and determining the nature, timing and extent of further audit procedures.

11. Determining Materiality and Performance Materiality. Cont..

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Considerations in identifying a benchmark:

i. The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
ii. focus on of users e.g on profit, revenue or net assets;
iii. The nature of the entity, e.g life cycle; industry; economic environment e.t.c
iv. The entity's ownership structure and financing
v. The relative volatility of the benchmark.

Examples of benchmarks include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities.

When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

12. Revision of Materiality as the Audit Progresses

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

13. Documentation.

The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole;

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;

(c) Performance materiality and

(d) Any revision of (a)–(c) as the audit progressed

Example 1 – Determining Materiality

The engagement team of entity A is in the process of determining materiality for the current period's audit. The entity is a listed entity in the publishing business. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations. Engagement risk has been determined as normal and no circumstances have been identified that would lead the engagement team to apply a percentage to the benchmark that is outside the normal percentage range (10% of PBT).

Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 7.5% to be applied to the chosen benchmark. The engagement team has estimated profit before tax from continuing operations for the current period to be 335,060,000. Applying the chosen percentage, 7.5%, to the benchmark amount, 335,060,000, gives Kshs. 25,129,500. The engagement team consequently determines materiality for entity A to be Kshs. 25,000,000.

Example 2 – Determining Materiality

The engagement team of entity B is about to determine materiality for the entity which is a listed entity that develops and sells computer games. The entity's management has informed the engagement team that there are strong indications that the entity will be acquired within the next 12 month by one of the country's largest media groups.

The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations. There have been no significant changes in the entity's business, management or internal control. Using professional judgment, based on knowledge of the users of the entity's financial statements and considering the fact that the entity is likely to be acquired during or shortly following the period under audit, the engagement partner has chosen 5% to be applied to the chosen benchmark.

The engagement team has estimated profit before tax from continuing operations for the current period to be 147,350,000. Applying the chosen percentage, 5%, to the benchmark amount, 147,350,000, gives 7,367,500. The engagement team consequently determines materiality for entity B to be 7,500,000

Example 3- Determining Materiality

Entity C is a listed entity that manufactures and sells office supplies. The entity has been our client for a number of years and the engagement risk has been determined as normal. The entity has had a slow but steady growth in revenue and dividends. It has inconsequential external debt and finances most investments by internally generated funds.

The entity has a history of few identified misstatements and the engagement team has assessed its internal control as very effective. There have been no significant changes in the entity's business, management or internal control during the period. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

Due to the entity's low external debt and knowledge of the entity as having effective internal control and accurate financial reporting, the engagement partner has chosen 10% to be applied to the chosen benchmark. The engagement team has estimated profit before tax from continuing operations for the current period to be 833,250,000. Applying the chosen percentage, 10%, to the benchmark amount, 833,250,000, gives 83,325,000. The engagement team consequently determines materiality for entity C to be 83,000,000.

Example 4- Determining Materiality

An engagement team is in the process of determining materiality for entity F. The entity is a privately owned entity in the forestry business. Both revenue and profit before tax varies significantly between years due to the fact that the optimal timing for harvesting the trees depends both on the current market price of timber and related products and the availability of appropriately mature trees for harvesting.

The entity has significant external debt. Due to these circumstances, the engagement partner has determined that the most appropriate benchmark to use in determining materiality is net assets. Engagement risk has been determined as normal and no circumstances have been identified that would lead the engagement team to apply a very high or a very low percentage to the benchmark.

Using professional judgment the engagement partner has chosen 3% to be applied to the chosen benchmark. The engagement team has estimated net assets for the current period to be 12,850,000. Applying the chosen percentage, 3%, to the benchmark amount, 12,850,000, gives 385,500. The engagement team therefore determines materiality for entity F to be 400,000.

Example 1- Determining Performance Materiality

- Materiality for entity AA has been set at 5,000,000 for the current period audit and the engagement team is about to determine performance materiality next. Entity AA is an IT consulting firm and there have been no significant changes in the entity's business, internal control, risks of material misstatement or management. The entity has been our client for the last five years and the uncorrected misstatements have been in the region of 20% - 30% of materiality during the client relationship. Last audit's uncorrected misstatement amounted to 1,034,280 (none of which carry over to this period). The engagement team determines performance materiality to be 3,500,000.

Example 2 – Determining PM

For the following audit of entity AA, materiality has been set to 5,000,000 again. The uncorrected misstatements in the previous audit were 1,243,257. There have been no significant changes in the entity's business, internal control or risks of material misstatement but the entity has partly new management starting a few months in to the current period.

In planning meetings with management they declared that they intend to correct all identified misstatements, unless clearly trivial, going forward. Considering the above circumstances, the engagement team determines performance materiality to be 4,500,000.

Interactive Session


THANK
You!

Presenter's Contacts

BUKAS
Accountancy & Consulting Limited

CPA Cyprian Oluoch

Cyprian.angawa@bukasconsultancy.com

Cangawa@gmail.com

Mobile No. 0724-665391