

# CHAPTER 4

## *The Why and How of Audit Planning*

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Now it's time to develop your materiality and planning documents.

### **Audit Materiality, Audit Strategy, and Audit Plan**

To be in compliance with audit standards, you need to develop your planning materiality, audit strategy, and audit plan

As you create your materiality, strategy, and plan, remember your ultimate goal: the audit opinion. And what does it say? That the financial statements are fairly stated (if the opinion is unmodified). But how do we know if the financial statements are fairly stated? Materiality.

### **Planning Materiality**

Materiality is a financial reporting concept, but we use it in auditing.

The Financial Accounting Standards Board defines materiality this way:

“The omission or misstatement of an item in a financial report is material if, in light of the surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.”

This definition is not a formula such as one percent of total

revenue (or any other computation), but we need clearly defined boundaries, don't we? That's why auditors compute materiality using formulas. Even so, materiality is also qualitative.

**Examples of material misstatements include:**

- Misstatements of a financial statement line
- The omission of a significant disclosure
- An incomplete disclosure
- An unreasonable estimate

Computed materiality is the level of acceptability for any of the above. But, again, qualitative factors are considered. For example, related party transactions might merit a lower materiality.

**Auditors create layers of materiality including:**

- Financial statement materiality
- Performance materiality
- Particular account materiality

In computing materiality, what should you consider?

**Materiality Considerations**

First, consider the common needs of the readers. Readers of financial statements—management, owners, lenders, vendors, and others—make decisions based on the audited information. You should develop materiality in light of their common needs.

Second, consider which benchmark to use. Some examples are total revenues, total assets, or net income. Choose a benchmark that is relevant and stable. Often total assets or total revenues are good choices.

Third, determine appropriate percentages to apply to the benchmark.

## Financial Statement Level Materiality

How do you create your financial statement materiality (also called planning materiality)? Usually, you will apply a percent to a benchmark. You might, for example, use one percent of total assets.

But what percentages should you use? Most CPAs defer to third-party publishers that provide materiality forms. Others create their own percentages. Either way, materiality must be reasonable. What is reasonable? The Financial Accounting Standards Board defines materiality as an omission or misstatement “such that it is probable that the judgment of a reasonable person...would have been changed or influenced by the inclusion or correction of the item.”

## Performance Materiality

Undetected misstatements can adversely affect our consideration of materiality.

What if, for example, your materiality is \$100,000? And what if the passed adjustments are \$90,000 and undetected misstatements total \$50,000? In such a situation, an unmodified audit opinion might *appear* to be correct—even though material misstatements are present. You need a cushion to lessen the risk that uncorrected misstatements and undetected errors exceed materiality. But how? By using performance materiality.

What is performance materiality? It is the use of materiality at a transaction or account or disclosure level (rather than at the financial statement level). For example, performance materiality for cash could be \$150,000 and financial statement materiality could be \$200,000. In this example, a detected error of \$175,000 in cash would not be acceptable.

How does performance materiality differ from financial statement materiality? Performance materiality is applied at a transaction or account or disclosure level. Financial statement materiality applies to the entity as a whole.

Performance materiality calls for thresholds at the account level (e.g., receivables/revenue) and is usually calculated using 50% to 75% of financial statement materiality. Why the range? To provide room for judgment.

If the risk of material misstatement is low, then a higher percent might be merited. If the risk of material misstatements is high, then a lower percent (e.g., 55% of materiality) can be used. Also, if your client is not inclined to record detected misstatements, use a lower percent. You don't want misstatements—in whatever form—to wrongly influence the decisions of financial statement users.

### **Particular Account Materiality**

Additionally, you may use—in some instances—an even lower materiality (that is, lower than your performance materiality). You, for example, might desire greater assurance with regard to an estimate. If you are auditing a bank's allowance for loan losses, you might use 25% of materiality (or an even lower percent). Why use a lower percent? Because this estimate is complex and risky.

### **Materiality is Iterative**

As you perform your audit, revisit your initial materiality computations. Audit adjustments might change the initial benchmark totals. For instance, if audit adjustments increase total assets, then materiality should increase accordingly, assuming total assets is your benchmark.

In addition to materiality, document your audit strategy.

## Developing Your Audit Strategy

What should you include in your audit strategy? AU-C 300.08 states that the audit strategy should include:

- The characteristics of the engagement
- The reporting objectives
- The significant factors
- The results of preliminary engagement activities
- Whether knowledge gained on other engagements is relevant

Also, consider what resources you need to perform the engagement. Will you need a specialist? Do you need data mining software? What audit team members do you desire?

The audit strategy is the big picture. Here you document considerations such as:

- The scope (what are the boundaries of the work?)
- The objectives (what are the deliverables?)
- The significant factors (is this a new or complex entity?)
- The risk assessment (what are the risk areas?)
- The planned resources (what team members do you need?)
- The timing (when is the audit due?)

Should the audit strategy be lengthy? Not necessarily. For smaller entities, it can be a short memo. What are we after? A summary of risks, needed resources, and objectives.

**An audit strategy could, for example, address the following:**

- Deliverables and deadlines
- A time budget
- The audit team
- Key client contacts
- New accounting standards affecting the audit
- Problems encountered in the prior year
- Anticipated challenges in the current year

- Materiality
- Partner directions regarding key risk areas
- References to risk assessment work papers (those that support the strategy)

In addition to the strategy, you need an audit plan, sometimes referred to as the audit program.

## **Developing Your Audit Plan**

The audit plan is the linkage between planning and further audit procedures. What are “further audit procedures”? They are the actions to be taken in response to the risks of material misstatement. These actions include substantive procedures and tests of controls. The audit program links back to the identified risks and points forward to the substantive procedures and test of controls.

## **Creating the Audit Program**

How—in a practical sense—do you create audit programs? Most auditors tailor their prior year audit programs. That works as long as you revise them to address the *current* year risks. Audit programs are not static documents—at least, they should not be. The current year audit programs *can* be the same as last year, as long as the risks are the same. But if risks are different, then change the audit programs accordingly.

## **Sufficient Audit Steps**

How do you know if you have adequate audit program steps? Look at your risks of material misstatement (RMM)—which should be assessed at the assertion level (e.g., completeness). Audit steps should address all high and moderate RMMs in material transaction classes.

Additionally, AU-C 330.18 says the auditor is required to apply substantive procedures to all relevant assertions related to each

*material* class of transactions, account balance, and disclosure. So, the audit program should include steps for all material areas, even if risk is assessed at low.

For example, if plant, property, and equipment is material and all related assertions are assessed at low, plan and perform audit procedures for this area. If the existence assertion is relevant (and it usually is), then plan an audit step to address it. You could, for example, vouch invoices supporting additions to property.

If the RMM is high, then the audit plan should include additional steps to address those risks. For example, if there is a risk that fictitious vendors might be added, plan procedures to address that risk.

If the RMM is moderate, you'll perform standard audit procedures for that area. For example, if the existence assertion for cash is moderate, you might plan to test bank reconciliations.

If the RMM is low and the transaction area is not material, then audit procedures can be minimal. After all, your audit opinion addresses material misstatements.

As you build your audit plan, link your risk assessments to your audit programs.

### **Linking Risk Assessment with the Audit Program**

How can you integrate your risk assessment with your audit programs? Linkage, which is the process of connecting risk assessment and responses. On the risk assessment work paper, the auditor might say, "Because the controller can add new vendors and process payments by himself, we will perform a test for fictitious vendors." Then the auditor adds an audit program step to test for this risk. By doing so, the auditor links the risk assessment to the response.

We can also create linkage by putting relevant assertions next to each audit step. Then the RMMs and audit procedures are connected. For example, if your risk assessment for the accounts payable completeness assertion is high, then put a C (for completeness) next to your search for unrecorded liabilities audit program step. Now the risk (the understatement of payables) is linked to the audit step (the search for unrecorded liabilities).

## **Creating Efficiency in the Audit Plan**

In developing your audit program procedures, remember you have two options: substantive procedures and test of controls.

Once you complete your risk assessment work, ask, “Which is more efficient? Testing controls or performing substantive procedures?” Then plan accordingly.

Generally, I assess control risk at high. While auditors can’t default to a high control risk assessment, they can—once the risk assessment work is complete—decide to assess control risk at high.

Why do I often assess control risk at high? Because I don’t desire to test controls (often involving a sample of forty to sixty items—or more) for effectiveness. Control risk assessments below high must be supported by a test of controls. If controls are not tested, then there is no basis for the lower control risk assessment. But the testing of controls often takes more time than the alternative: substantive procedures.

For example, suppose a company pays two invoices totaling \$4.1 million (98% of the total property additions for the year). Is it more efficient to vouch two invoices or test the property controls? More than likely, vouching invoices. In this situation, I elect to assess property control risk at high—that way, I don’t have to test the operating effectiveness of the controls.

Nevertheless, this logic—substantive tests take less time than testing controls—is often *less* true for more complex organizations. Larger businesses process more transactions and tend to have better controls. So it *can* be better to test controls for some entities. I also believe that a test of controls for effectiveness is more useful in some transaction areas such as receivables, payables, and payroll.

The choice is yours. You can perform substantive procedures or you can test controls—or you can do both. The important thing is to respond to identified risks.

### **Audit Planning - A Simple Summary**

- Materiality is a financial reporting concept used in auditing
- Financial information is material if omitting it or misstating it could influence users' decisions
- Performance materiality is the application of materiality at a transaction level or account balance level such as receivables (and is often 50% to 75% of financial statement materiality)
- An even lower materiality percent can be applied to risky areas (e.g., a bank's allowance for loan losses)
- Document your audit strategy as a summary of objectives, resources, and risks
- Create your audit plan (audit program) based on identified risks
- Audit programs should address all moderate to high risk assessments for each significant audit area
- The auditor is required to apply substantive procedures to all relevant assertions in each *material* class of transactions, account balances, and disclosures (even if all RMMs are low)
- The audit plan can include substantive procedures, test of controls, or a combination of the two

There you have it: the creation of the audit strategy and the audit plan. Your strategy includes the risks, needed resources,

and objectives. And your audit programs are responsive to the identified risks. You are good to go. Now it's time to perform your procedures.

**In the upcoming chapters, we will look at how to audit:**

- Cash
- Accounts receivable and revenues
- Investments
- Property
- Accounts payable and expenses
- Payroll
- Debt
- Equity