Chapter 6
Planning an Audit

Full chapter infographic: Part A (LO 1-4) and Part B (LO 5-8)

1 Part A: Planning activities

Meaning of planning
- Setting the direction of the work before detailed procedures
- 2 steps: (1) overall audit strategy: scope, timing, direction; (2) audit plan: nature, timing and extent of procedures for each F/S area

Who is involved
- A team activity: engagement partner and other key team members must participate

Why planning is important
- Complete the engagement efficiently
- Identify and resolve risks and problems on time
- Focus on important and high-risk areas
- Select the right team, assign work
- Direct, supervise, review staff
- Coordinate with component auditors and experts

Documentation of planning
- The overall audit strategy
- The audit plan
- Significant changes during the audit, with reasons

2 Overall audit strategy vs audit plan

Overall audit strategy: scope, timing
- Guides development of the audit plan

1 Engagement characteristics
- Reporting framework (e.g. IFRS)
- Industry-specific requirements
- Number and location of components
- Need for specialized knowledge
- Internal audit function and use of its work
- Effect of IT on procedures
- Availability of client personnel and data
- Use of prior-period evidence

2 Reporting objectives
- Reporting deadlines
- Meetings with management and TCWG
- Nature and timing of reports, management letter, TCWG communication, component auditors' reports

3 Factors directing team
- Materiality thresholds
- Areas of high risk
- Rely on internal controls or focus on substantive procedures
- Recent developments in law, accounting or industry
- Emphasis on professional skepticism

4 Resources required
- Timing of resources (e.g. use staff in interim audit)
- Level of staff and expertise for high-risk areas
- How to direct, supervise and review team

5 Preliminary engagement
- Knowledge from prior audits and procedures at acceptance or continuance stage

Audit plan
- More detailed than the strategy; turns approach into specific procedures per F/S area
- Includes nature, timing and extent of risk assessment procedures
- Further audit procedures at assertion level: tests of controls (if relying), substantive procedures
- Usually presented as audit programmes (step-by-step instructions)

3 Additional planning for an initial audit engagement

1 Acceptance
- Check client integrity, firm competence, ethical compliance

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2 Discuss
- Major issues (accounting policy disagreements, scope limits); communicate effect on audit planning to TCWG

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3 Predecessor
- Communicate and, if allowed, review working papers

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4 Opening bal.
- Obtain sufficient appropriate evidence

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5 Quality
- Extra measures, e.g. independent partner review

4 Interim audit vs final audit

Interim audit (before year-end)
- Covers systems and transactions up to interim date
- Understand entity; assess inherent risk
- Document and test internal controls
- Preliminary analytical procedures
- Test P&L transactions to interim date
- Identify issues for the final audit
- Advantages: earlier identification of matters, flexible resource planning, quicker reporting for stakeholders, less year-end workload

Final audit (at or after year-end)
- Concludes with the opinion on F/S
- Agree F/S to accounting records
- Examine adjustments during F/S preparation
- Cut-off of sales and purchases
- Substantive testing of transactions after interim date
- Confirmations (banks, lawyers, debtors, creditors)
- Management representation letter
- Inventory count attendance
- Subsequent events; final analytical procedures; going concern

5 Part B: Materiality

What is materiality?
- Significance of misstatements or scope limitations
- Material if omission or misstatement, individually or in total, could influence users' economic decisions
- Depends on size and nature of the misstatement

Purpose in audit
- Planning: decide nature, timing, extent of risk assessment procedures; identify risks
- Performing: guide design and execution of further procedures
- Reporting: evaluate uncorrected misstatements and form opinion

Quantitative formula
- Materiality = chosen benchmark x chosen percentage

Step 1: Users of F/S
- Profit-oriented entity: shareholders
- Heavy borrowings: debt-holders or bankers
- Not-for-profit: trustees or members

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Step 2: Benchmark
- Select benchmark that reflects user focus and apply a suitable percentage

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Step 3: Perf. mat.
- Set lower than overall materiality so total uncorrected and undetected misstatements do not exceed overall

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Step 4: Qualitative
- Nature of misstatement may make a small amount material

Benchmark	Suitable % (rule of thumb)	When used
Profit before tax	5%	Profit-oriented entity
Revenue or expenses	1%	Not-for-profit or entity incurring losses
Total assets, net assets or equity	1%	Banks, mutual funds, highly leveraged entities
Cash flow from operations	3% to 5%	If primary user is a bank

Documentation of materiality
- Overall materiality
- Performance materiality
- Basis of computation (benchmark and percentage)
- Any revisions during the audit

6 Qualitative materiality

Meaning
- Ignore the size of misstatement; focus on its characteristics or impact
- Even a small misstatement can be material if it affects user decisions

Common examples
- 1 Disclosures required by law or framework (related parties, directors' remuneration)
- 2 Disclosures users focus on in certain industries (R&D in pharma, newly acquired business)
- 3 Non-compliance with law (illegal payments, money laundering)
- 4 Fraud
- 5 Small misstatements that convert profit into loss (or vice versa), affect key ratios or debt covenants, cross an important threshold, affect share capital or directors' pay

7 Revision in materiality

When revised?
- New information changes initial assessment: changes in risk; change in understanding of the entity; differences between draft and actual F/S; change in circumstances (e.g. sale of a major segment)

Effect of revision
- Performance materiality
- Risk assessment
- Nature, timing and extent of audit procedures
- Reducing materiality: risk up; more and larger samples, closer year-end testing

8 Performance materiality

What is it?
- A threshold below overall materiality
- Ensures the sum of small misstatements does not make the F/S materially misstated
- May also apply to specific transactions, balances or disclosures where user focus is high
- Example: overall materiality Rs. 5m minus prior uncorrected Rs. 1.5m = Rs. 3.5m

How is it determined?
- Misstatements found in prior periods
- Expected misstatements in current period
- Understanding of the entity and its controls
- Engagement risks
- Significant changes in the business