CHARTA LEARNING · INTERVIEW PREPARATION

Audit Planning, Risk and Materiality

Interview preparation summary · AU track

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INT.UP.1.a · Understanding the client

Explain what an auditor learns about a client's business, industry and environment before planning, use that knowledge to point to risk areas, and say what must be checked before accepting the engagement.

Before an auditor plans any testing, the auditor has to understand the client: what it sells and to whom, how it earns money, who owns and runs it, how it is financed, the industry it operates in, the laws and reporting framework that apply, and how performance is measured. Auditing standards require this understanding because misstatements arise where the business is complicated, changing or under pressure, and you cannot judge what looks wrong until you know what normal looks like. The usual sources are management inquiries, prior year files, industry reports, board minutes, and a comparison of this year's results with last year's through ratios and trends. Separately, the firm decides whether to accept or continue the engagement. It considers the integrity of management and owners, whether the team has the competence, time and independence to do the work, the fee, and whether the client's activities create legal or reputational risk. A common mistake is to treat this as a form-filling step. Interviewers want to hear that you use it to find where the numbers could go wrong.

WORKED EXAMPLE: READING BRINDLE GARDEN CENTRES BEFORE PLANNING

Brindle Garden Centres is an invented retailer with 14 stores and a seasonal trading pattern. This year revenue was 84.0m (last year 78.0m), cost of sales 52.1m (last year 46.8m), and year-end inventory 14.7m (last year 11.2m). The audit manager asks you for a first view of where the risks are and what to check before the firm accepts the work. Convention: inventory days are year-end inventory divided by cost of sales, times 365.

Answer: The first risk areas are inventory existence and valuation, and the cause of the margin fall. Inventory grew 31.2% on revenue growth of 7.7%, and days rose from 87 to 103. The firm should also complete its acceptance checks on integrity, independence and capacity.

> **Interview tip:** Quote two or three computed trends, say what each could mean for the business, then name the audit risk it creates. Finish with one line on acceptance, so the interviewer hears that you know the firm decides whether to take the client at all.

INT.UP.1.b · Understanding the client

Explain inherent risk, control risk and detection risk, how they combine in the audit risk model, and how the assessed risks of material misstatement change the work the auditor must do.

Audit risk is the risk of giving a clean opinion on financial statements that are materially misstated. The audit risk model breaks it into parts. Inherent risk is how likely a balance or disclosure is to be misstated before considering any controls, for example because it involves estimates, complex rules or high volumes. Control risk is the risk that the client's controls fail to prevent or catch that misstatement. Together they make the risk of material misstatement, assessed by the auditor at assertion level. Detection risk is the risk that the auditor's own procedures fail to find a material misstatement that exists. The auditor cannot change the first two, only assess them, but controls the detection risk through the nature, timing and extent of testing. When the risk of material misstatement is high, the acceptable detection risk is low, so the auditor tests more, tests nearer the year-end, and uses stronger evidence. In practice auditors usually assess risks as high, medium or low rather than as percentages. The common mistake is to say that good controls mean no testing is needed; some substantive work is always required.

WORKED EXAMPLE: SETTING DETECTION RISK FOR TWO BALANCES AT KESTREL FABRICATIONS

Kestrel Fabrications is an invented metal parts manufacturer. The audit team targets an overall audit risk of 5% for each balance. For work in progress, the team judges inherent risk at 90% and control risk at 60%. For the payroll balance, inherent risk is 50% and control risk 40%. What detection risk is acceptable for each, and what does that mean for the work? Convention: the numbers are an illustration only, because firms normally assess risk as high, medium or low.

Answer: Acceptable detection risk is about 9.3% for work in progress and 25% for payroll. The higher the risk of material misstatement, the lower the detection risk the auditor can accept, so work in progress needs more extensive, later and stronger testing.

> **Interview tip:** Explain the formula in words first, then run the two cases and say what it means for the work. Mention that firms use high, medium and low in practice, to show you know the model is a way of thinking, not an exact calculation.

INT.UP.1.c · Understanding the client

Identify significant risks and fraud risks, explain why revenue recognition and management override are treated as fraud risks, and describe how the audit response differs for them.

A significant risk is a risk of material misstatement that, in the auditor's judgement, needs special audit attention because of its nature or the size or likelihood of the misstatement. Typical examples are complex or unusual transactions, large estimates, and anything involving fraud. Auditing standards presume that there is a fraud risk in revenue recognition, so the auditor treats it as significant unless there is a reason to rebut the presumption in that client's circumstances, and treats management override of controls as a significant risk on every audit, because management can manipulate records and override controls that otherwise look fine. For significant risks the auditor must understand and evaluate the design of relevant controls, and cannot rely on analytical procedures alone: the response needs tests of detail aimed at the specific risk. For revenue this often means cut-off testing, contract review and confirmations; for override it means testing journals, reviewing estimates for bias and examining unusual transactions. Fraud risk factors are pressure or incentive, opportunity and rationalisation. The usual mistake is to list every risk as significant, which dilutes the focus.

WORKED EXAMPLE: A YEAR-END SALES PATTERN AT QUILLON SOFTWARE

Quillon Software is an invented company that sells annual licences. Fourth-quarter revenue this year was 18.4m, of which 6.9m was booked in the last three days of the year. Last year the figures were 16.2m and 1.9m. Overall materiality is 1.1m. Management bonuses depend on reaching a revenue target. Is there a significant risk, and what is the response?

Answer: Yes, revenue is a significant fraud risk. 37.5% of fourth-quarter revenue fell in the last three days against 11.7% last year, an unusual amount of 4.7m, which is 4.3 times materiality. The response is targeted contract, cut-off and journal testing.

> **Interview tip:** Say it in the order: what is unusual, why it matters, which assertion is at risk, then the specific tests. Avoid saying analytics alone would be enough, because for a significant risk the interviewer expects tests of detail.

INT.UP.2.a · Materiality and the plan

Set overall materiality, performance materiality and a clearly trivial threshold from a benchmark, and explain the judgement behind the benchmark and percentage chosen.

Materiality is the size of misstatement that would be expected to influence the economic decisions of users of the financial statements. It is a judgement, not a formula. The auditor sets overall materiality for the statements as a whole, usually by choosing a benchmark that users care about and applying a percentage. Common rules of thumb are a small percentage of profit before tax for a profit-making company, a small percentage of revenue or total assets where profit is volatile or not the focus, and of expenditure for a charity, but practice varies and the firm's methodology decides. Where profit is unusually high or low this year, many auditors use an average or normalised figure. Performance materiality is set below overall materiality, often at 50% to 75% of it, so that the total of uncorrected and undetected misstatements stays below the overall figure. The weaker the control environment or the more past errors, the lower the percentage. A clearly trivial threshold, often around 5% of overall materiality, is the level below which misstatements are not accumulated. A common mistake is to treat the percentage as a fixed rule.

WORKED EXAMPLE: SETTING MATERIALITY FOR CORVANE PACKAGING

Corvane Packaging is an invented manufacturer with revenue of 310m. Profit before tax was 12.4m this year, and 9.6m and 13.4m in the two previous years. The audit team uses 5% of normalised profit before tax as a starting point, 75% for performance materiality and 5% for the clearly trivial threshold. Set the three thresholds and explain the choices. Convention: round materiality to the nearest 0.01m.

Answer: Overall materiality is 0.59m (5% of the three-year average profit before tax of 11.8m), performance materiality 0.44m and the clearly trivial threshold 0.03m.

Interview tip: Name the benchmark, justify it in a sentence by reference to who uses the statements, and show the three levels in order. Say that you would document why the percentage was chosen, because the judgement is what the manager reviews.

INT.UP.2.b · Materiality and the plan

Scope the components of a group audit using their size and risk, and explain how the audit strategy and plan turn the risk assessment into the nature, timing and extent of procedures, resources and a timetable.

The overall audit strategy sets the scope, timing and direction of the audit; the audit plan then lists the specific procedures, by area, who does them and when. Both follow from the risk assessment: higher risks get more experienced staff, more evidence and work nearer year-end, while low risk areas may get analytical procedures only. In a group, the auditor decides which components need work. A component that is individually significant by size, for example 15% or more of group revenue or assets under a common rule of thumb, usually receives a full-scope audit. Other components may receive specific procedures on high-risk balances, or only group-level analytical procedures when they are small and low risk. Component materiality is set below group materiality so that errors across components do not add up to more than the group figure. Planning also covers the use of specialists, the work of internal audit, the use of component auditors, and a timetable for interim and final visits. The common mistake is to scope only on size and ignore a small but high-risk component.

WORKED EXAMPLE: SCOPING THE HALDEN GROUP

Halden Group is an invented group with six components. Revenue in millions is: Alder 120, Brook 85, Cairn 60, Dene 40, Elm 25 and Fenn 20. The team uses 15% of group revenue as the threshold for a full-scope audit. Dene holds a large inventory with a history of errors. Decide the scope and work out the coverage. Convention: coverage is measured by revenue.

Answer: Full scope for Alder, Brook and Cairn (75.7% of revenue), specific procedures for Dene (87.1% cumulative coverage), and group-level analytics for Elm and Fenn (12.9%).

Interview tip: Show that you scope on both size and risk. Say that coverage is a rule of thumb, and mention that the group team still directs and reviews the component work.

INT.UP.2.c · Materiality and the plan

Accumulate identified misstatements, separate factual, judgemental and projected misstatements, compare the total with materiality, and say how qualitative factors and changes in circumstances affect the conclusion.

During the audit the team records misstatements it finds, other than those below the clearly trivial threshold. There are three types. Factual misstatements are not in doubt, such as a sale recorded in the wrong period. Judgemental misstatements arise from estimates or accounting policy choices where the auditor and management differ, such as a provision. Projected misstatements are the auditor's best estimate of the error across a population when a sample has been tested. The team totals them and compares the aggregate with overall materiality and performance materiality, asks management to correct them, and considers the effect of those left uncorrected. Even a total below materiality needs thought, because a small misstatement can be material by nature, for example if it turns a loss into a profit, breaches a covenant, affects directors' pay or involves fraud. Materiality should also be revised if circumstances change, such as actual results differing greatly from the draft figures used in planning. The usual mistake is to compare each misstatement separately with materiality rather than their total.

WORKED EXAMPLE: TOTALLING MISSTATEMENTS AT WEXFORD TEXTILES

Wexford Textiles is an invented company. Overall materiality is 2.0m, performance materiality 1.5m and the clearly trivial threshold 0.1m. All the items below overstate profit. A cut-off error of 0.42m and an accrual error of 0.15m are factual. In a sample of inventory worth 8.0m out of a population of 40.0m, errors of 0.16m were found. A provision difference of 0.38m is judgemental. A further error of 0.06m was found. What is the position? Convention: project the sample error pro rata to the untested part of the population.

Answer: The total of misstatements is 1.75m, 87.5% of overall materiality and above performance materiality of 1.5m. Below materiality does not mean acceptable. The team should request correction and consider qualitative factors.

Interview tip: Describe the three types of misstatement, add them, compare the total with both thresholds, and then bring up qualitative factors. That last step is what shows you understand that materiality is a judgement.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.