AUDIT ANALYTICS®

Audit, Regulatory & Disclosure Intelligence

Assessing Materiality

A Classroom Exercise

Objectives

Section I:
Planning Materiality

- ✓ Be able to **calculate materiality** for the financial statements as a whole
- ✓ Be able to **identify accounts or disclosures** that need individual planning materiality

Section II:
Performance Materiality

- ✓ Be able to **articulate the difference** between planning materiality and performance materiality

Section III:
Evaluating Results

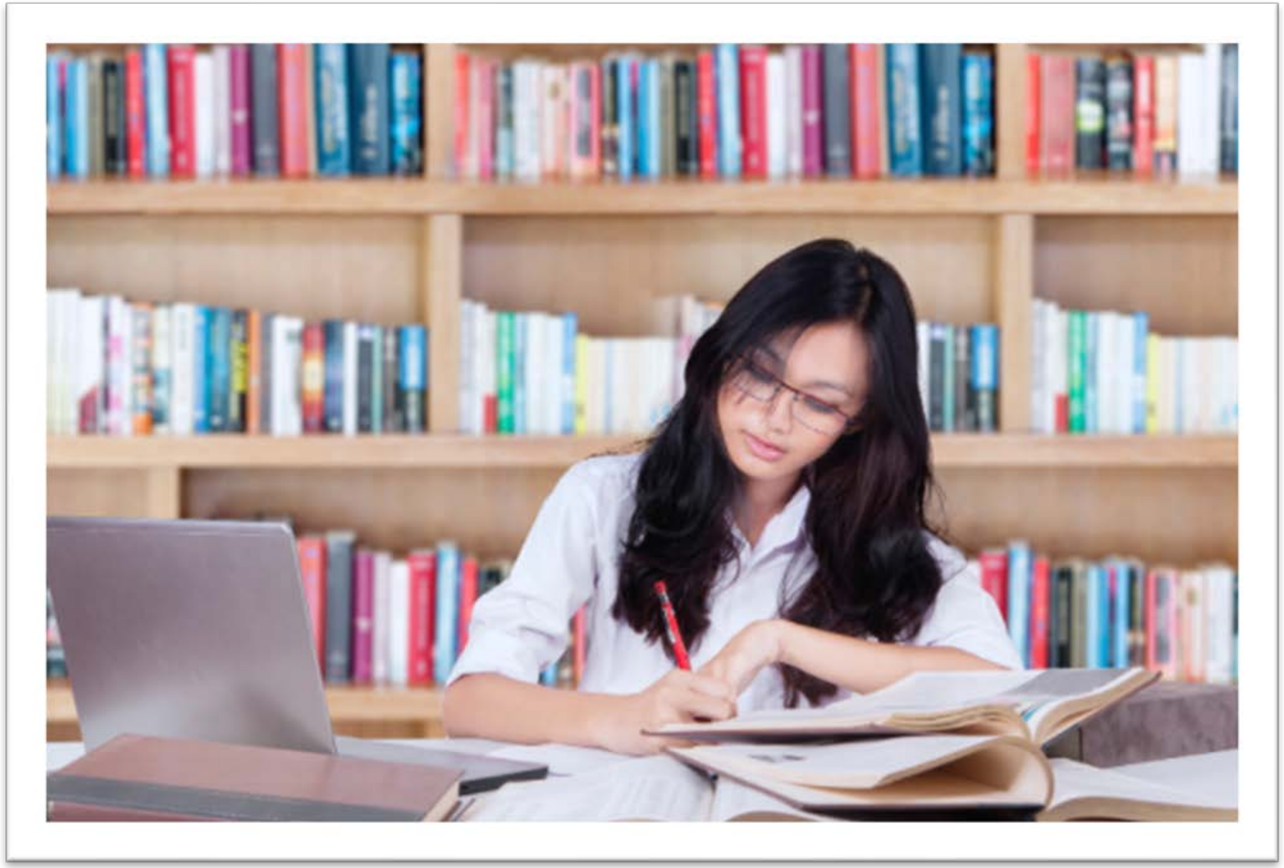
- ✓ Be able to **evaluate materiality** of errors discovered during the audit process
- ✓ Be able to **suggest a method** appropriate for correcting the error

Assessing Materiality for Yum! Brands Inc.

In this assignment, you are engaged to lead an audit of Yum! Brands Inc. for fiscal year 2018.

As the engagement partner, you'll have to work with your team to determine Yum! Brands Inc.'s planning materiality and performance materiality.

You are also tasked with evaluating the company's audit results following an identified misstatement.



Section I:

Planning Materiality

What is Planning Materiality?

The concept of planning materiality is set by the Public Company Accounting Oversight Board's (PCAOB) AS 2105

Auditing Standard 2105.06:
Establishing a Materiality Level for the Financial Statements as a Whole

> *"To plan the nature, timing, and extent of audit procedures, the auditor should establish a **materiality level** for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount."*

International Perspective on Planning Materiality

In some countries, auditors must disclose planning materiality in the audit report.

These countries use different auditing standards – usually the International Auditing and Assurance Standards Board's (IAASB) International Standards on Auditing (ISA).

ISA 320.10:
Determining Materiality and Performance Materiality When Planning the Audit

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

See supplements for example audit reports.

Calculating YUM! Brands Inc.'s Planning Materiality

The planning materiality calculation will depend on the company's risk profile and the industry in which the company operates.

Some examples of planning materiality calculations include:

- ~1% of Revenue
- ~2% of Gross Profit
- ~5% of Operating Income
- ~1% of Total Assets
- ~2% of Shareholder's Equity

Select YUM 2018 Financial Statement Items	
Revenue	$5,688,000,000
Operating Profit	$2,296,000,000
Total Assets	$4,130,000,000
Shareholder's Equity	($7,926,000,000)

Go to Yum! Brands Inc.'s full financial statements

Additional Considerations

Auditors may also establish a narrower planning materiality for specific accounts or disclosures for which a misstatement could influence the judgement of a reasonable investor.

Auditing Standard 2105.07:
Establishing Materiality Levels for Particular Accounts or Disclosures

> *"The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures."*

Questions

What would be an appropriate metric to use when calculating Yum! Brands Inc.'s planning materiality? – *Why?*

Calculate Yum! Brands Inc.'s planning materiality.

Are there any other particular accounts or disclosures that require separate planning materiality levels?

Section II:

Performance Materiality

Assessing YUM! Brand Inc.'s Performance Materiality

Audits are designed to provide a ***reasonable*** level of assurance rather than total assurance.

Because of this, planning materiality must be refined to account for the work being performed and the level of assurance being attained.

What is Performance Materiality?

The concept of performance materiality is set by the PCAOB's AS 2105.

Auditing Standard 2105.08:
Determining Tolerable Misstatement

> *"The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly,* ***tolerable misstatement should be less than the materiality level for the financial statements as a whole*** *and, if applicable, the materiality level or levels for particular accounts or disclosures."*

Questions

How is **performance materiality** different from **planning materiality**?

What would an appropriate measurement of performance materiality be for Yum! Brands Inc? – *Why?*

Calculate Yum! Brands Inc's performance materiality.

Section III:

Evaluating Audit Results

How to Evaluate Audit Results

The concept of audit result evaluation is set by the PCAOB’s AS 2810.

Auditing Standard 2810.03-.04:
Evaluating the Results of the Audit of Financial Statements

“.03 In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

.04 In the audit of financial statements,1 the auditor's evaluation of audit results should include evaluation of the following:

- The results of analytical procedures performed in the overall review of the financial statements ("overall review");
- **Misstatements accumulated during the audit, including, in particular, uncorrected misstatements;**
- The qualitative aspects of the company's accounting practices;
- Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");
- The presentation of the financial statements, including the disclosures; and
- The sufficiency and appropriateness of the audit evidence obtained.”

How to Evaluate Audit Results (*continued*)

Auditing Standard 2810.17-.18:
Accumulating and Evaluating Identified Misstatements

".17 The auditor should evaluate whether **uncorrected misstatements are material, individually or in combination with other misstatements**. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

.18 The auditor's evaluation of uncorrected misstatements, as described in paragraph .17 of this standard, should include evaluation of the **effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years**."

Evaluating YUM! Brand Inc.'s Out-of-Period Adjustment

During the second quarter of 2018, the Company **discovered an error** in their accounting for income taxes.

Read the following disclosure from Yum! Brands Inc.

> *"Our second quarter effective tax rate was lower than prior year primarily due to the favorable impact of the $32 million benefit described below, the favorable impact of the reduction in the U.S. federal statutory tax rate and lapping the prior year cost of repatriating foreign earnings. This benefit was partially offset by a* ***$19 million charge recorded in the quarter ended June 30, 2018 for the correction of an error associated with the tax*** *recorded on a prior year divestiture."*

Look for companies in similar industries that have **restated** or **adjusted** their financial statements for similar reasons during the same period.

Questions

Based on planning and performance materiality, do you believe it was appropriate for Yum! Brands Inc. to correct the error as an out-of-period adjustment rather than a restatement? – *Why?*

Would you reassess Yum! Brands Inc.'s decision to record the correction as an out-of-period adjustment instead of a restatement based on how peers corrected similar errors? – *Why?*

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