AUDIT MATERIALITY

Summary:

Materiality is one of the basic and major concepts of auditing. Auditing and Assurance Standard (AAS) (hitherto known as Standard Auditing Practices (SAPs))-13, "Audit Materiality", states that the concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of the financial information in conformity with recognised accounting policies and practices. There are no sets of rules or prescriptions that may be applied consistently to determine materiality in all circumstances. Materiality is a relative terms. What may be material in one circumstance may not be material in another. The assessment of what is material is a matter of professional judgement and experience of the auditor.

In this paper, concept of materiality concept of audit risk, auditor's consideration of materiality while making an opinion on the financial statements, etc. are discussed in brief. The matters that are to be considered, among other things, by the auditor to decide on materiality are also outlined.

Introduction:

Materiality is one of the basic and important concepts of auditing. Auditing and Assurance Standard (AAS) (hitherto known as Standard Auditing Practices (SAPs))-13, "Audit Materiality", establishes standards on the concept of materiality and its relationship with audit risk. AAS-6 (Revised), "Risk Assessments and Internal Control", provides guidance and establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components.

The true and fair presentation of the financial statements depends, among other things, upon the concept of materiality. Materiality is a relative term. What may be material in one circumstance may not be material in another. The consideration of materiality is the matter of professional judgement and experience of the auditor. There are number of matters that are to be considered to decide on materiality. But, however, there are no sets of rules or prescriptions that may be considered and applied consistently to decide on materiality in all circumstances. In this paper, some matters are discussed, which may be considered by the auditor while making materiality assessments.

Concept of Materiality:

Materiality concept is one of the most important concepts of auditing. The materiality concept should be considered by the auditor before making an opinion on the financial statements. The client or management of the entity has the responsibility to ensure that whether the financial statements reveals all relevant material information. When material information is not disclosed or materially misstated, the financial statements will not present true and fair picture. It will not be possible for the auditor to make an opinion on the financial statements without considering materiality concept. The assessment of what is material is the matter of professional judgement and experience of the auditor.

AAS-13, "Audit Materiality", establishes standards on the concept of materiality and its relationship with audit risk which is another important concept of auditing. According to it "information is material if its misstatement (i.e. omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful".

There are no specific rules or prescriptions that can be followed in all circumstances to assess materiality. It is the matter for the auditor to decide whether a particular misstatement or an item has material impact on the financial statements or not.

Audit Objective and Materiality:

The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. Such opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise. The materiality concept has an important role in relation to the true and fair presentation of the financial statements. Part II of schedule VI to the Companies Act, 1956, requires that the profit and loss account should disclose every material feature. The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of the financial information in conformity with recognised accounting policies and practices. The auditor should consider materiality at both the overall financial information level and in relation to individual account balances and

classes of transactions. It is necessary for the auditor to obtain sufficient appropriate audit evidence which may be influenced by the materiality of the item, before making an opinion on the financial statements.

Matters Influencing Materiality:

There are number of factors which may influence materiality. For example, legal and regulatory requirements, including the requirements which made mandatory by the Institute of Chartered Accountants of India (ICAI) and by the competent authority. The contravention of or non-compliance with such requirements may have a significant bearing on the financial information, and considerations relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

Concept of Audit Risk:

AAS-2, "Objective and Scope of the Audit of Financial Statements", states that due to the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered. According to AAS-13, "Audit Materiality", there is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high.

AAS-6(Revised), "Risk Assessments and Internal Controls", identifies the three components of audit risk i.e. inherent risk, control risk and detection risk. According to it-

"Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

"Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

"Control risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

“Detection risk” is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.

AAS-6 (Revised), “Risk Assessments and Internal Control”, provides detailed guidance on how to assess audit risk and establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components. AAS-6 (Revised), “Risk Assessments and Internal Control” may be read with AAS-4 (Revised), “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements”, which considers audit risk and its components with reference to fraud and error factors.

Audit Risk and Materiality:

As stated earlier, there is an inverse relationship between materiality and the degree of audit risk. When conducting an audit, the auditor should consider materiality and its relationship with audit risk. The level of detection risk can be considered only after considering the level of inherent and control risks. While planning an audit, the auditor should keep in mind that the audit risk is to be kept at an acceptably low level. The range, efficiency, efficacy, nature and timing of the procedures performed by the auditor will determine the level (i.e. high or low) of detection risk. The nature of evidence is also an important factor that may determine the level of detection risk. For instance, the external evidence like confirmations or certificates from third parties like bank may reduce the level of detection risk than internal evidence.

During Audit Function:

The views and results of assessments established, in respect of inherent and control risks, by the auditor and upon which the audit was initially planned may be changed during the course of audit. Because the audit may have been planned with a view that there is a possibility low inherent and control risks. After considering some matters and information which may come to the auditor’s knowledge, during the course of audit, it may be decided subsequently that the planned procedures will not low the audit risk and they may not sufficient to uncover the material misstatements, if any. In such situation, the auditor should change, or adopt alternative or additional, audit procedures so as to keep the level of audit risk at an acceptably low level. By performing appropriate substantive audit procedures, the level of audit risk can be kept at an acceptably low level.

Materiality and Reporting:

The auditor may require the client or management of the entity to correct the errors or misstatements, if any, which may be material or immaterial, identified. If the

client or management has not corrected, any or all of such errors or misstatements, then the auditor should aggregate such errors or misstatements to assess the level of material effect on the financial information. Where the material misstatements are not corrected in the financial information, the auditor should make qualified report. Qualitative considerations also influence the auditor in reaching a conclusion as to whether the misstatements are material.

Extending the Audit Procedures:

When the auditors tests an account balance or class of transactions by an analytical procedure, ordinarily it would not possible to specifically identify misstatements but an indication of whether misstatements might exist in the balance or class, and possibly its approximate magnitude, would be obtained. If the analytical procedure indicates that misstatements might exist, but not its approximate amount, the auditor ordinarily should employ other procedures to estimate the aggregate misstatement in the balance or class. When audit sampling is used by the auditor to test an account balance or class of transactions, the amount of known misstatements identified in sample to the items in the balance or class from which such sample was selected should be projected. Such projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

Determining Materiality:

There are no sets of rules or prescriptions that may be applied consistently for determining audit materiality. What may be material in one circumstance may not be material in another. Part II of schedule VI to the companies Act. 1956, requires that the profit and loss account should disclose every material feature. The users of the financial statements expect that the financial statements should be reliable and should disclose all the material information in respect of financial matters of the entity. While conducting an audit the auditor should adopt appropriate audit procedures and measures to identify material misstatements and to assess them to make an opinion on the financial statements. Whenever the auditor faces a difficult situation to decide whether a particular misstatement is material or not, its impact, either individually or when aggregated with other misstatements, on the financial statements of current period, or its expected impact, either individually or when aggregated with other misstatements, on the financial statements of later periods, should be considered. The points discussed below may be considered by the auditor to identify material misstatements and to assess its material effect on the financial statements.

1. Legal and Regulatory Requirements:

The legal and regulatory requirements should be considered by the auditor to determine materiality of an item. Legal requirements are the requirements which are required by the law. For instance, the Companies Act, 1956, lays down the limits on

remuneration that can be paid to the directors. If any payment is made to the directors as remuneration in excess of such limits, it will become material even though the amount so paid may be small. Regulatory requirements are the requirements which made mandatory by the government, appropriate or concerned authority and by the Council of the ICAI. For instance, the Companies (Auditor's Report) Order, 2003, (issued under section 227 (4A) of the Companies Act, 1956), a series of Accounting Standards issued by the Council of the ICAI, etc.

The auditor must consider the legal and regulatory requirements before making an opinion on the financial statements. AAS-21, "Consideration of Laws and Regulations in an Audit of Financial Statements", establishes standards on the auditor's responsibility regarding consideration of laws and regulations in an audit of financial statements and discusses the matter in detail. The law, which governs the business of the client or entity, may prescribe the forms and the contents of the financial statements according to which the client or entity should prepare and present the financial statements. For instance, section 211 of the Companies Act, 1956, deals with the matters of form and contents of the balance sheet and the profit and loss account.

Where the auditor finds that the legal or regulatory requirements, if applicable, are not followed or not complied with or contravened in the preparation and presentation of the financial statements covered by the audit, or where the audit is to be performed in accordance with such requirements (e.g. requirements like AAS) and when the auditor has not been able to perform the audit in accordance with such requirements, the fact should , with reasons, if applicable , be adequately disclosed in the audit report so that the user of the financial statements may be aware of such non-compliance with, or such contravention of, legal or regulatory requirements. Paragraphs 21, 22 and 23 of AAS-1, "Basic Principles Governing an Audit", may be noted in this regard.

2. Percentage Comparison:

The percentage comparison may be a useful tool in determining materiality of an item. For instance, part II of schedule VI to the Companies Act, 1956, requires that any expense exceeding one per cent of the total revenue of the company or Rs. 5000 whichever is higher should be shown as a separate and distinct item against an appropriate account head in the profit and loss account and should not be combined with any other item to be shown under "Miscellaneous Expenses".

3. Abnormal Transactions, etc.:

The nature of transaction or the size of the amount involved in a transaction should be taken into account to judge the materiality of an item. The transaction or amount of abnormal, non-recurring or exceptional nature may have certain degree of material effect on the financial information. This category includes any amount of

unusually large where the amount was expected or projected to be insignificant. Part II of schedule VI to the Companies Act, 1956, provides that the profit and loss account should disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature. For example, the expenses of a company in respect of foreign travel may be material where the company's objects does not requires or comprises the transaction of business outside India.

4. Relative Significance:

To judge the materiality of an item, its relative significance may be considered. It means consideration of a particular item on the basis of other items which has close relationship with that item. For instance, a particular item of current asset or current liability may be viewed on the basis of total current assets or total current liabilities.

5. Previous Year Figures:

The materiality of an item can be considered by comparing it with the corresponding figure in the previous year. For example, if the amount of an item of the current year is very low or high while comparing it with the corresponding figure in the previous year then it may become material when compared to the corresponding figure of the previous year.

6. Differences in Calculations, etc.:

It has been recognised that no accounting estimates can be considered to be 100% accurate. However, if there is any difference between the calculations or estimates made by the client or management of the entity and by the auditor, such difference should be considered to decide its material effect on the financial statements. When such difference is reasonable it may be recognised as a "soft difference" and may be ignored. On the other hand, if such difference is unreasonable it may be recognised as a "hard difference" and should be considered by the auditor to judge its material effect on the financial statements. It should be ensured that whether the difference ignored, recognising as soft difference, has material effect on the financial information when aggregated with other soft difference(s).

7. Prior Period Misstatements:

In prior periods, misstatements may have been considered immaterial and may have been ignored accordingly. Such misstatements may affect the financial information of the current period. In such cases, the auditor should consider the material effect of

such misstatements, individually or when aggregated with the current period misstatements, if any, on the financial statements.

8. Prospective Material Misstatements:

Sometimes the auditor may judge that the immaterial misstatements, of prior periods or of current period, which has been ignored on the grounds of materiality, may affect the financial information of the later periods. In such cases, the auditor may require the client or management of the entity to correct such misstatements. If such misstatements are not corrected, it may be proper for the auditor to refer the fact thereof in the audit report. It may defend the auditor in legal consequences, if any, which may lie in future.

9. Immaterial Misstatements:

The immaterial misstatements, if any, should be considered by the auditor to conclude that whether such misstatement has material effect cumulatively on the financial statements. The possibility of undetected immaterial misstatements should also be considered. In certain situations, the immaterial misstatements may have material effect, when aggregated with undetected misstatements, if any. Where the auditor establishes that there may be a wide possibility of undetected immaterial misstatements, then detected immaterial misstatements should be corrected and therefor the auditor may require the client or management of the entity.

10. Accounting Policies and Fundamental Accounting Assumptions:

The accounting policies helps to show the material items in the financial statements against appropriate account head and at appropriate amount value. One of the major considerations governing the selection and application of accounting policies is "materiality", i.e. the accounting policies should be selected and applied with a view to disclose the material items in the financial statements appropriately and at correct amount value . All significant accounting policies adopted in the preparation and presentation of the financial statements should, as far as possible, be disclosed in one place, forming part of the financial statements, so as to ensure proper understanding of the financial statements. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which

the change is adopted. [See sub-sections (3A), (3B) and (3C) of section 211 of the Companies Act, 1956].

Specific disclosure is not required if the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual, are followed in the financial statements. If a fundamental accounting assumption is not followed, the fact should be disclosed. However, disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. It is the responsibility of the client or management of the entity to ensure that whether the accounting policies once adopted has been followed consistently and disclosed appropriately, or if there is any change in the accounting polices, whether the fact thereof has been disclosed appropriately. [See section 217 (2AA) of the Companies Act, 1956].

Conclusion:

The consideration of the materiality of an item is the matter of professional judgement and experience of the auditor. The financial statements must contain all the material information to show true and fair picture. AAS-2, "Objective and Scope of the Audit of Financial Statements", states that the auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

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References and Sources:

1. The Accounting Standards (AS) and the Auditing and Assurance Standards (AAS) (hitherto known as Standard Auditing Practices (SAPs) issued by the Council of the Institute of Chartered Accountants of India; and

2. "Audit Materiality" by Dolphy D'Souza. (The Chartered Accountant, August, 2001).

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