MATERIALITY IN AUDIT – SA320

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CONCEPT

- As per SA 320, misstatements are material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of the users taken on the basis of financial statements.
- The amounts below the materiality threshold – individually or in aggregate – are not always immaterial.
- The Auditor shall assume that the users –
  - ❖Have reasonable knowledge of business and economic activity.
  - ❖Understand the financial statements.
  - ❖Recognize the inherent uncertainties in use of estimates and judgements.
  - ❖Can make reasonable economic decisions.
- The judgment of materiality is based on surrounding circumstances (i.e. materiality criteria) and size and nature of misstatement.

RELATIONSHIP WITH AUDIT PROCESS

- The concept of materiality is fundamental to the audit process. It is applied by the auditor for –
  - ➢Risk assessment.
  - ➢Determining the nature, time and extent of audit procedures to gather sufficient and appropriate audit evidence.
  - ➢Evaluating the effect of identified and uncorrected misstatements on the financial statements.
  - ➢Forming the audit opinion and report.

ILLUSTRATIVE MATERIAL MISSTATEMENTS

Following is illustrative list of material misstatements –

- One that changes loss into profit and vice versa.
- One having impact on compliance with debt covenants (e.g. current ratio, DSCR etc.)
- One having impact on contractual agreements.
- One having impact on compliance of regulatory provisions.
- One having effect on variable compensation payable to KMP.
- One emanating from fraud or omission or commission.
- One having significant impact on financial statements.
- One having impact on the image of the entity.

TYPES OF MATERIALITY

- Overall materiality is a ***threshold*** above which the financial statements could be misstated and would affect the economic decision of the user of the financial statements. It depends on the size of the organization, types of transactions, character of management and auditor’s judgement.
- Performance materiality – it is an amount less than overall materiality. It acts as a safety buffer to lower the risk of aggregate uncorrected and undetected misstatements which could be material for overall financial statements.
- Specific materiality – it is established for ***class of transactions, account balances and disclosures***.
- Inverse relationship exists between audit risk and materiality. ***Higher the audit risk, lower will be the materiality.***

DETERMINING THE MATERIALITY

- For determining the overall materiality, following steps are involved –
  - Risk assessment and risk classification into – low, medium or high.
  - Selecting the appropriate benchmark and financial data for the selected benchmark.
  - Determining the percentage to be applied to the selected benchmark depending upon the risk assessment.
- The various benchmarks are generally used for materiality. One can make use of single benchmark or multiple benchmarks. The selection of single or multiple benchmark will depend on following 2 factors –
  - Grade of the audit risk. (i.e. Low, Medium or High)
  - Type of organization.

DETERMINING THE MATERIALITY

- If the risk is high, the auditor may use multiple benchmarks as under –
  - For overall materiality – gross revenue.
  - For specific materiality related to items of profit & loss account – gross profit or PBT.
  - For specific materiality related to assets – total assets.
  - For specific materiality related to liabilities – shareholders' equity.
- Depending upon the absolute value of above benchmarks, the auditor may use different percentages for determining materiality. E.g. – in case of lower amount of absolute value of benchmarks, the percent could be high and in case of large amount, the percent could be low.

DETERMINING THE MATERIALITY

- The selection of benchmark also depends on the type of entity – as under –
  - In case of new unit – gross turnover would be the benchmark.
  - In case of entity for profit – normalized profit.
  - In case of NPO – total expenses.
  - In case of heavy debt financing – total assets.
  - In case of liquidity crunch – total equity.
  - In case of entities working in public utilities – total cost of project.
  - In case of volatility in profit – gross profit.

MATERIALITY AND AUDIT

- The penetration and performance of audit will depend on 3 factors - Decision about the risk, materiality and sampling.
- It is necessary to decide the materiality during the audit plan stage only.
- It is also necessary to evaluate the materiality again during the process of audit and accordingly adopt or modify audit techniques and sample selection.
- Even after deciding the materiality, it is not possible to check each and every item above materiality level due to time and cost constraints. Hence use of appropriate sampling methods is necessary.
- The sampling can be done on the basis of Benford Analysis, statistical random sampling or selective sampling.

MATERIALITY AND AUDIT

- Benford is used for selecting the samples from large number of repetitive transactions like sales or purchases or cash. This technique needs to be augmented by use of statistical random sampling.
- For Journal entries, Bank transactions, Account balances & Disclosures - selective sampling is a better technique.
- It is necessary to prepare documentation about materiality and sampling and preserve them as working papers.
- Additional techniques like balance confirmations from banks, debtors and creditors, analytical procedures like comparative statements or Ratio analysis should also be used.

MATERIALITY AND AUDIT

- The use of following ICAI published material is also necessary.
  - ❖Implementation guide on materiality.
  - ❖SA 315 - ROMM
  - ❖SA 320 – Materiality in audit
  - ❖SA 450 – Evaluation of misstatement
  - ❖SA 500 – Audit evidence
  - ❖SA 501 - Audit evidence – selected items
  - ❖SA 505 – External confirmations
  - ❖SA 520 – Analytical procedures
  - ❖SA 530 – Audit sampling

MATERIALITY DOCUMENTATION

- After deciding the materiality as per the worksheet, it is necessary to prepare proper documentation describing the process of deciding materiality & the conclusions.
- Process description –
  - ❖The materiality criteria used for assessing the Risk. - **A**
  - ❖Classification of risks – No risk, Low risk, Medium Risk & High risk. **B**
  - ❖Weightage of risk – On scale of 0 to 10. **C**
  - ❖Relation between marking & risk grade. **B & C together.**
  - ❖Overall risk assessment depending upon the percentage marks scored. **D**
  - ❖Benchmark selected based on the type of entity for overall materiality. **E**
  - ❖ Description of various benchmarks for calculating specific materiality. **F**

MATERIALITY DOCUMENTATION

- Description of pre-defined % for various levels of overall materiality. **G**
- Description of pre-defined % for various levels of specific materiality for transactions, account balances and disclosures. **H**
- Absolute benchmark amount **I**
- Final overall materiality & specific materiality threshold amounts. **J**
- Triviality % and amount based on overall materiality. **K**
- List of exceptional, non-recurring & unusual amounts excluded from the Benchmark amount.

THANK YOU