SA 320
MATERIALITY
IN PLANNING AND PERFORMING AN AUDIT

This is very important standard. Just imagine this

Say you are the auditor; you sent one article assistant to one of your clients and that client's total assets are Rs. 500 crore. Assume, the assistant called you and saying *"Sir, I found a mistake of Rs. 250. What to do*?". It looks funny to us. But it is the duty of the auditor to tell the assistant that for this client Rs. 2 crore would be our materiality and ask him to inform you if the total error crossing this limit. This standard gives guidance on materiality.

Remember this is a new Standard – so you will learn new words / terminology;

Introduction

You already have an idea about Materiality. You must have read it in AS – 1 "Disclosure of accounting policies"

- In general, Materiality is an **amount or information** which affects the economic decisions of the users of financial statements; But remember, as per this SA **materiality** should be from the **point of view of the Auditor**.
- So, the materiality in audit should be decided by the auditor; It is purely a professional judgement of the auditor;
- his SA guides the auditor on measurement of materiality in planning and performing an audit of FS;

WHAT IS THE IMPORTANCE OF MATERIALITY?

The auditor's objective is to obtain reasonable assurance about whether the financial statements as a whole are free from **material misstatement**, whether due to fraud or error; This enables him to express an opinion on whether the financial statements are prepared, in **all material respects**, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

If the auditor does not fix the materiality, how does he decide what is material misstatement and how does he assess the material risk? *Let us learn in detail*

Materiality in the Context of an Audit

Determination of Materiality is a matter of professional judgement of the auditor;

Whether the particular information/item is material can be judged from:

(a) Its size/amount;

(b) Its nature *(E.g. Abnormal, non-recurring, extraordinary, etc.);*

(c) Its legal requirements *(E.g. As per Section 52 of Companies Act, 2013, Securities Premium cannot be used for declaring dividend – In this case, amount is not considered);*

(d) Its qualitative materiality *(E.g. Fraud committed by managing director of small amount – it is a matter of reliability not amount);*

(e) Items may be immaterial individually but it may be material cumulatively, i.e., in aggregate; *(E.g. An error of Rs. 1000 in one transaction may be immaterial but if the same is repeated number of times it may be material).*

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

If the auditor decides an item is material – accordingly he decides the nature, timing and extent of audit procedures to be performed;

In the same way, if he identifies a misstatement – he can decide whether it is material or not and what should be the action for this?

Asked in exam

Explain concept of 'Materiality' and factors which act as a guiding measure to this concept.

Concept capsule 30

An assistant of X & Co., Chartered Accountants detected an error of Rs.5 per interest payment which recurred number of times. The General Manager (Finance) of T Ltd advised him not to request for passing any adjustment entry as individually the errors were of small amounts. The company had 2,000 Deposit Accounts & interest was paid quarterly. Comment as per SAs.

Suggested answer

As per SA 320, Materiality should be considered individually and in aggregate.

In the given case, we can find out that individually errors are of Rs. 5 only but when we consider total effect of the same then it involves a big amount and which should be treated as material transaction.

The auditor should, therefore, determine the cumulative error and then take a decision as to whether an adjustment is required or not. Accordingly, they need not pay any attention to the advice made by the General Manager (Finance) of T Ltd.

Asked in exam ***(CA Inter – May 2022)***

Materiality is not a matter of size. Is it correct?

Answer

Incorrect: Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example -a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases, quantitative limits of materiality are specified.

DETERMINATION OF MATERIALITY

Auditor should determine **Materiality** and **Performance Materiality** when Planning the Audit When establishing the overall audit strategy;

Materiality is determined for the financial statements as a whole; Say Materiality fixed for an entity is Rs. 10 Crore. It means, even if the financial statements contain **total misstatement of Rs. 10 Crore** also, auditor is ready to express unmodified opinion (clear opinion) on the financial statements *(read it once again – it is FS – including BS, P&L & Notes);*

Remember this - **Total error** means identified & Unidentified errors.

How does auditor decide materiality?

Determining materiality involves the exercise of professional judgment. **A PERCENTAGE** is often applied to a chosen **BENCHMARK** as a starting point.

The percentage is purely a professional judgement and it depends on the bench mark; i.e., if bench mark is Revenue (Sales), auditor may take a small percentage *(like 1%)* and if it is PBT– auditor takes comparatively better rate *(like 5%).*

Say Benchmark is Profit before tax = Rs. 100 Crore; Auditor wants to take 1% of PBT as materiality; Hence, materiality = Rs. 100 Crore * 1% = Rs. 1 Crore. It further means, the maximum acceptable error in the financial statements is Rs. 1 Crore, i.e., if the total error (identified and unidentified) is less than the materiality, auditor can express an unmodified opinion.

The following are the factors to identify an appropriate Benchmark:

(a) The elements of the Financial Statements (*For example* - Assets, Liabilities, Equity, Revenue, Expenses)

(b) Items on the Financial Statements in which the **users focus**; (*Generally users may focus on the profit, revenue (sales), total assets, etc);*

(c) The **Nature of the Entity**, where the entity is at in its life cycle and the **industry and economic environment** in which the Entity operates;

(d) The Entity's **ownership structure** and the way it is financed (*For example,* if an Entity is financed solely by Debt rather than Equity, users may put more emphasis on Assets, and claims on them, than on the Entity's earnings); and

(e) The relative volatility of the Benchmark.

Examples of benchmarks are Profit before tax (PBT) from continuing operations is **often used** for **profit-oriented entities**. If PBT is very **volatile**, other benchmarks such as gross profit or total revenues can be applied.

Auditor **can fix** different materiality for different items of financial statements like one materiality for P&L items, different for Balance sheet items & disclosures, one more for legal items;

The auditor shall **determine performance materiality** for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

> ***Asked in Exam***
>
> Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Discuss stating the factors that may affect the identification of an appropriate benchmark. ***(CA Inter - Nov 2020)***

> ***Asked in Exam*** ***(CA Inter – Dec 2021)***
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> When Profit before tax from continuing operations is **non-volatile**, other benchmarks will be appropriate.
>
> **Incorrect**: Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is **volatile**, other benchmarks may be more appropriate, such as gross profit or total revenues.

WHAT IS PERFORMANCE MATERIALITY?

Performance materiality is the amount or amounts set by the auditor *at less than materiality* for the financial statements as a whole to **reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality** for the financial statements as a whole (to reduce detection risk to an acceptably lower level).

I think, you did not understand completely – still I suggest you to read the above definition once again. Answer the following questions

As determined above materiality is Rs. 1 crore for an entity, i.e., the total error (identified and unidentified) in the financial statements accepted to give unmodified opinion.

Say

Auditor identified total errors of Rs. 1 Crore.

Does he give unmodified or modified opinion?

Ans: Modified. Remember Rs. 1 crore is **identified** It does not include unidentified errors.

Is auditor checking 100% items in the financial statements?

Ans: NO. It means, auditor did not check 100% items. It further means that there will be some unidentified errors in the financial statements. Let us say, auditor is expecting Rs. 20 lakh unidentified errors in the financial statements, then *total errors in the financial statements would be Rs. 120 lakh* (identified Rs. 100 lakh + unidentified and expected is Rs. 20 lakh) and this is not acceptable for unmodified opinion.

In the given situation, as auditor is expecting Rs. 20 lakh **unidentified** errors in the financial statements, he fixes the **performance materiality = Materiality - Expected unidentified errors** = Rs. 100 lakh – Rs. 20 lakh = Rs. 80 lakh.

In a way, performance materiality means it is the maximum amount of **identified error** that can be acceptable to express an unmodified opinion.

As you understood, performance materiality is always less than materiality amount. By keeping a lower amount, auditor performs **more audit procedures** and it automatically reduces the detection risk to acceptably low level.

How to determine unidentified error?

It involves the exercise of professional judgment.

Current year unidentified errors can be expected based on

- the <u>understanding of the entity</u> based on risk assessment procedures performed under SA 315; and
- the nature and extent of <u>misstatements identified in</u> <u>**previous audits.**</u>

Hope you understood it better.

If auditor keeps different materiality's for BS, P&L, disclosures separately, he should fix different performance materiality for each item.

What is the relation between Materiality and Audit risk?

There is an **INVERSE relationship** between materiality and audit risk.

- Audit risk means the risk that the auditor gives an inappropriate audit opinion when financial statements are materially misstated; Audit opinion is based on the audit evidence obtained by performing **audit procedures**;
- Based on materiality auditor determines nature, timing and extent of **audit procedures**.
- So, there is a relation between materiality and audit opinion, i.e., audit risk;

Inverse relation: Higher the materiality level, the lower the audit risk and *vice versa*.

***How is that*?**

If an item is **very material**, auditor will take less chance of having fraud / error, i.e., auditor performs a great extent of audit work and that automatically **reduces the audit risk**.

In the same way, if the transaction is **not material** then probably it **may have been ignored** by the auditor during the process of test audit **and** that may lead to high chance that frauds and errors may have been involved within such transactions which remain undiscovered even after conclusion of work of audit.

The auditor should try to reduce the audit risk to an acceptable level by

(a) Reducing the assessed degree of control risk by carrying out extended or additional test of control *(i.e., compliance procedures as discussed in SA 500)*; or

(b) Reducing detection risk by modifying the nature, timing and extent of his substantive procedures, *i.e., by performing more extent of audit procedures*.

REVISION OF MATERIALITY DURING THE AUDIT

The auditor **shall revise** materiality for the financial statements as a whole **or** the materiality level for particular classes of transactions, account balances or disclosures (if fixed separately) in the event of **becoming aware of information during the audit that would have caused the auditor to have determined a different amount initially**. *(read again)*

*In my example, I took the benchmark of PBT as Rs. 100 crore. If, during the audit if he is aware of misstatement and due to which PBT is reduced to Rs. 90 Crore. Then auditor must revise the materiality from Rs. 1 Crore to Rs. 90 lakh (i.e., Rs. 90 Crore * 1%).*

If the auditor concludes that a lower materiality than that initially determined is appropriate, the auditor shall determine

(a) whether it is necessary to **revise performance materiality** (because performance materiality is based on materiality); and

(b) whether the nature, timing and extent of the further audit procedures remain appropriate. *(This is because when Rs. 1 crore what was not checked earlier, may be required to be verified when materiality is reduced to Rs. 90 lakh)*

Asked in MTP

Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. **(MTP-Nov- 2019)**

Concept capsule 31

As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, he wants to re-evaluate the materiality concept. Please, guide him.

Suggested answer

In the instant case, Mr. P, as an auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate the materiality concept on the basis of additional information of significant contractual arrangements which draws attention to a particular aspect of the company's business.

As per SA 320, auditor should fix the materiality as a whole or if required, he can fix separate materiality for P&L, BS and notes. For this, he should fix a bench mark based on industry, previous experience, volatility of benchmark, etc.

The auditor shall revise materiality for the financial statements in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially i.e. if the benchmark amount is changed.

If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

Thus, Mr. P can re-evaluate the materiality concepts after considering the necessity of such revision.

Documentation

The auditor should document the following:

(a) **Materiality** for the financial statements as a whole;

(b) ***If applicable***, the materiality level or levels for particular classes of transactions (P&L), account balances (BS items) or disclosures (notes);

(c) **Performance** materiality; and

(d) Any revision in above (a) to (c) during the audit.

Concept Capsule 32

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor.

Suggested answer

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Concept Capsule 33

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act,2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

Suggested answer

If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

AUDIT IN AN AUTOMATED ENVIRONMENT

Students are expected to have knowledge in information technology studied in group II **and** SA 315 before reading this chapter.

Now-a-days almost all entities are using information technology-based systems and applications. These systems generate and process a transaction without involvement of human. *Instead of withdrawal money from a bank we can withdraw from ATM, company can sell the goods online and collect money without interference of human.*