

Audit Materiality and Risks-An Overview

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< EXECUTIVE SUMMARY >

◆ In the auditing parlance, a financial information is supposed to be material if its omission or misstatement could influence the economic decision of the users taken on the basis of the financial statements. Materiality normally depends on the size and nature of the item, which is mainly judged in the particular circumstances of its omission or misstatement. According to the concept of materiality, some matters individually or in the aggregate, are important for the fair presentation of the financial statements taken as a whole. The concept of materiality is funda-

mental to the process of recognition, aggregation, classification and presentation of financial information. However, materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. It provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have, if it is to be useful. This article narrates some important aspects related to the concept of audit materiality and the risks connected therewith. It also slightly deals with the auditor's duties involved therein.

WHAT IS AUDIT MATERIALITY?



he IASC defines the concept of audit materiality as follows:

‘An information is material if its omission or misstatement could influence the economic decision of the users taken on the basis of the financial statements’.

AAS 13, Audit Materiality, issued by the Institute of Chartered Accountants of India also states that “infor-

mation is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decision of the users taken on the basis of the financial statements’ Materiality depends on the size and nature of the item, judged in the particular circumstances of its omission or misstatement”.

AS 1, Disclosure of Accounting Policies, issued by the ICAI, defines material items as “items, the knowledge of which might influence the decisions of the user of the financial statements”. The concept of materiality thus recognises the fact that some matters individually or in the aggregate, are important for the fair presentation of the financial statements taken as a whole. The concept of materiality is fundamental to the process of recognition, aggregation, classification and presentation of financial information. However, materiality depends on

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the size of the item or error judged in the particular circumstances of its omission or misstatement. It provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have, if it is to be useful.

Audit risk and materiality, amongst other matters, need to be considered by the auditors together in determining the nature, timing and extent of audit procedures and in evaluating the results of those procedures.

DETERMINANTS OF MATERIALITY:

Even though audit risk and materiality are to be considered by the auditors in determining the nature, timing and extent of audit procedures and in evaluating the results of those procedures, there are no hard and fast rules for determining materiality. What is material is a matter of pure professional judgment. For example, an amount that is material to the financial statements of one entity may not necessarily be material to the financial statements of another entity of a different size or nature. Further, what is material to the financial statements of a particular entity might change from one period to another.

In many cases, percentage comparisons may be more useful in determining the materiality of an item. Many audit firms in our country apply materiality criteria ranging from 1/2% to 1% of turnover or 5/10% of the net profits, as is relevant in a particular situation. However, exceptions are made in certain situations, for example:

- An otherwise immaterial payment to the managing director, in contravention of the Companies Act is material given the significance of these issues in India;
- Materiality for purposes of the details set out in Form 3CD (for tax audit purposes Under Income Tax Act, 1961) is zero;
- Materiality for purposes of Part II of Schedule VI disclosure under the Companies Act, 1956 is greater of 1% of turnover/ revenue or Rs.5, 000 etc.

Thus the determination of audit materiality may also be influenced by other considerations such as legal and regulatory requirements non-compliance of which may have a significant impact on the financial information provided by the entity.

AUDITOR'S RESPONSIBILITY:

The objective of an audit of financial statements is to enable the auditor to express an expert's opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

However, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or frauds that are not material to the financial statements are detected.

MATERIALITY AND AUDIT RISKS:

1. The concept of audit materiality has to be properly understood in relation to audit risks. Audit risk is the risk of giving a wrong opinion; i. e. the auditor giving a clean chit on the financial statements, which were materially misstated. Since 100% auditing is never done in any case, there will always be an element of audit risk in all audits. However, auditing is all about managing this audit risk and keeping it low to an acceptable level or permissible limit.
2. The auditor should consider materiality and its relationship with audit risk when conducting an audit. There is always an inverse relationship between materiality and audit risk. The risk that a particular account balance could be misstated by an extremely large amount might be low, but the risk that it could be misstated by an extremely small amount might be very high. If the risks are high, the materiality level will be low, so that the extent of audit checking is to be increased.
3. The auditor needs to consider audit risk at the individual account balance or class of transactions level in such a way that will enable him or her at the completion of the audit to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. The risks that a misstatement in the financial statement goes unnoticed comprise of:
 - The risk (inherent and control risk) that the financial statement taken as a whole are materially misstated.
 - The risk (detection risk) that the auditor will not detect such misstatements.

The way the auditor considers these risks and combines them involves professional judgment and

depends on the audit approach.

A. INHERENT RISK (IR)

1. Inherent risk is an audit risk which can be defined as the likelihood of a misstatement existing in an account balance or class of transactions that would be material when aggregated with misstatements in other accounts or classifications, assuming that there were no related internal controls. There are many factors that can affect the inherent audit risk. The important factors to be considered include the following:
 - i. the need for estimates,
 - ii. Sensitivity to external forces, and
 - iii. Characteristics of the industry in which the company operates.
2. There is less risk associated with an account that is based on actual transaction than one based on estimates. For instance, there is less risk associated with rent expense than with warranty expense based on this single factor, and there is more risk associated with the inventory of a company that is part of an industry that is experiencing rapid technological changes.
3. Certain account balances in the financial statements by their very nature carry a higher inherent risk. For example, in the case of construction contracts, the estimation process involves complex calculations and are more likely to be misstated than simple calculations. Further, cash is more susceptible to theft than a huge machinery installed in the factory.
4. External factors too influence inherent risk, for example, technological developments may make products obsolete or regulatory changes could significantly hamper the legitimacy of a business. For account balances or class of transactions where inherent risks are high, the level of materiality would be low and consequently the substantive work would be high.
5. Thus, the materiality levels and consequently the nature, timing and extent of audit procedures for each account balance (or classes of transactions) in the financial statements will be different depending on the level of inherent risk (and control risk) applicable to each of them.

B. CONTROL RISK:(CR)

1. Control risk is the possibility of a misstatement occurring in an account balance or class of transac-

tions that could be material when aggregated with misstatement(s) in other balances or classes, and that will not be prevented or detected on a timely basis by the system of internal control.

2. However, the control risk, like inherent risk cannot be changed by the auditor. The client's design of its internal control structure that produces the current financial statements must be treated as a given factor. Of course the auditor can make recommendations for improving the system, which may affect the audit engagement of the next period.
3. In general, the stronger the internal control structure, the more likely that material misstatements will be prevented or detected by the system. However, some control risks will always exist because of the inherent limitations of internal controls.

C. DETECTION RISK (DR)

1. Detection risk is defined as the risk that an auditor's procedures will lend to the conclusion that a misstatement in an account balance or class of transactions that could be material when aggregated with a misstatement in other accounts or classes does not exist when in fact such a misstatement does exist.
2. Detection risk arises because all items that comprise an account balance are not examined and audit procedures are not properly applied. Non-sampling misstatement includes inappropriate audit procedures, misapplication of an audit procedure, misinterpretation of audit results, use of incompetent staff, etc. These uncertainties can be managed by improving the audit firms quality standards.
3. Detection risks bear an inverse relationship to inherent and control risks. The lesser the inherent and control risk the greater the detection risk that can be accepted and vice-versa. It is not appropriate for an auditor to rely completely on assessments of inherent risk and control risk to the exclusion of performing substantive tests in the case of critical or high-risk audit areas.
4. Detection risk is a function of the risk associated with the substantive tests of details (RTD) and the risk associated with substantive analytical procedures (RAP). In other words, DR = RAP * RTD.

HOW TO CONSIDER MATERIALITY?

An auditor has to consider audit materiality at various stages of audit, viz,

1. At the planning stage:
2. At the time of audit
3. At the closing stage.

AT THE PLANNING STAGE:

1. At the time of designing the audit plan itself, the auditor should establish an ‘acceptable materially level’ so as to detect the quantitative material misstatements. The auditor needs to consider the possibility of several immaterial amounts that cumulatively have a material impact on the financial statements. For example, a computer error may have systematically replicated itself in the entire database.
2. The auditor has to consider both quantitative and qualitative misstatements. Qualitative misstatements would include improper description of an accounting policy, which is likely to mislead the user of financial statements or failure to disclose consequent imposition of regulatory restrictions, which may significantly impact the entity’s ability to continue as a going concern.
3. However, the nature, timing and extent of planning and thus of the considerations of audit risk and materiality vary with the size and complexity of the entity, the auditors’ experience with the entity, and his or her knowledge of the entity’s business.
4. Further, the auditors’ understanding of the internal controls may heighten or mitigate the auditors’ concern about the risk of material misstatement.
5. While considering the audit risks, the auditor should also specifically assess the risk of material misstatement of the financial statement of the financial statements due to fraud. High risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to end of the year, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.
6. The auditors’ assessment of materially related to specific account balances and class of transactions helps the auditor to decide such questions as what times to examine and whether to use sampling and analytical procedures. This enables the auditor to select the audit procedures that, in combination, can be expected to reduce audit risk, to an acceptable low level.
7. In case of multiple locations, the auditor should consider the extent to which audit work should be carried out at each location. This would however

depend on certain criteria such as:

- i. The size of the location and nature of transactions
- ii. Previous experience of that location, if known
- iii. The effectiveness of central controls, etc
8. In cases, where audit planning is done after financial statements are prepared, the financial statements would definitely serve as a basis for determining the materiality level. In other situations, the auditor’s judgment would be based on interim or forecast results, if due recognition is given to the effects of major changes in the entity’s business.

AT THE TIME OF AUDIT:

1. During the execution of audit, the evidence obtained may cause the auditor to modify the name, timing and extent of planned procedures.
2. Information may come to the auditors’ attention that differs significantly from the information on which the audit plan or materiality was based. In all such cases the auditor will have to reevaluate his plan and auditing procedures in a suitable manner.

AT THE CONCLUSIVE STAGE:

1. The auditor should aggregate misstatements that the entity has not corrected to consider whether in relation to individual amounts, subtotals or totals in the financial statements, they materially misstate the financial statements taken as a whole.
2. Qualitative considerations and regulatory requirements should also be considered.
3. If the auditor has estimated misstatement based on analytical review, and believes that it may not be a good approximation he must use other procedures to quantify the misstatement.
4. Where misstatements are identified in a sample, the auditor should project the misstatement to the population. Where population is skewed and does not represent a normal bell curve, extrapolation of sample errors to the population should be avoided and other alternative procedures should be used to quantify the misstatement in the population.
5. The auditor should also recognise the difference between an error and a soft difference. Since no accounting estimates can be considered to be 100% accurate, the auditor must recognise that the difference between his estimates and management’s estimates may be reasonable and could be ignored as a

- soft difference. However, if the difference is unreasonable it will constitute a misstatement.
6. In prior periods, misstatements may have been ignored on grounds of materiality. They might affect period financial statements. The auditor should include in aggregate misstatements the effect of prior period misstatements along with current years misstatements, if he believes that the current periods financial statements are likely to be misstated due to prior period misstatements.
 7. The auditor may designate an amount below, which misstatements may not be accumulated. This misstatement should be set so that any such misstatements, either individually or when aggregated would not be material to the financial statements, after considering the possibility of further undetected misstatements.
 8. If the material misstatements are not eliminated in the financial statements the auditor will have to qualify his opinion. If he concludes that the aggregation of likely misstatements does not cause the financial statements to be materially misstated, he should recognise that they could be materially misstated because of further misstatements remaining undetected.
 9. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality

level. Thus as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing the risk by performing addition audit procedures or by requesting management to adjust the financial statements for identified misstatements.

CONCLUSION

Thus, the concept of materiality is fundamental to the process of recognition, aggregation, classification and presentation of financial information. It is also an important factor for an auditor to judge whether a particular item or transaction is material or not. It is, however, ordinarily not practical for the auditors when planning an audit to anticipate all circumstances that may ultimately influence judgements about materiality in evaluating the audit findings at the completion of the audit. Thus the auditors' preliminary judgement about materiality may differ from the judgement about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating audit findings, the auditor should reevaluate the sufficiency of the auditing procedures he has performed. In short, the ideal approach auditors should take is to request their clients to make adjustments to the financial statements for the errors identified by him including immaterial errors unless they are really too insignificant to be of any financial consequence. ■

FOR THE INFORMATION OF MEMBERS

Introduction of New Formats of Monthly/Quarterly Return to be filed by SSI/Non SSI Manufacturers, Export Oriented Units and Registered Dealers

As a measure towards simplification of indirect tax procedures with the objective of reducing the complexities and the transaction cost, the monthly/quarterly returns to be filed by the manufacturer of excisable goods have been reduced to a unified, single and a simplified one page return(Notification No. 69/2002 Central Excise (NT) to 73/2003 Central Excise (NT), all dated 15-9-2003 refer). The details of the formats of the returns are available on CBEC website www.cbec.gov.in. The new returns will come into force from 1st October 2003.

Certain other changes in the Central Excise Rules, 2002 and the CENVAT Credit Rules, 2002 have also been carried out. Now the Export Oriented Units shall also be required to give details of the goods manufactured and exported under bond as well as the inputs and capital goods received without payment of duty in the monthly return filed by them. It may also be noted that full CENVAT credit of the duty paid on moulds and dies shall now be available to the manufacturer in the first year of acquisition itself. However, the credit on the moulds and dies received in the factory already before this amendment may be allowed as per the provisions existing earlier.