Consideration of Materiality in the Application of Accrual Basis of Accounting

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1 A government company is engaged in production of fertilizers and various nitrogenous chemicals. The company has four manufacturing units of which at present only one is operational. The company also has six marketing centres for marketing the company's products. Besides its own products, the company is also engaged in selling fertilizers and other ancillary products on consignment sales basis/outright purchase basis.

2 As per the accounting policy of the company, expenses incurred upto Rs. 25,000 relating to a future period are expensed in the current year.

3 The statutory auditors of the company, in their report to the shareholders, commented that the company has not complied with Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the Institute of Chartered Accountants of India, and section 209 (3) (b) of the Companies Act, 1956, which prescribes accrual basis of accounting, with regard to pre-paid expenses incurred upto Rs. 25,000.

4 According to the querist, the company has gone through the accounting policies of various companies and in all such cases, where companies have policy to charge expenditure upto a certain amount, though relating to a future period in the current period, none of the auditors have issued a qualified report.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 21 volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

B. Queries

5 The querist has sought the opinion of the Expert Advisory Committee on the following issues:

(a) Whether the aforesaid accounting policy of the company violates the provisions of AS 1 and section 209 (3) (b) of the Companies Act, 1956.

(b) If the answer to (a) above is in the affirmative, then how there is a difference in interpretation of the same by different auditors whereby the same accounting treatment is commented upon in one of the accounts whereas not in the others.

C. Points Considered by the Committee

6 The Committee notes that one of the major considerations governing the selection and application of an accounting policy is 'materiality'. The Committee notes that AS 1 requires that "financial statements should disclose all "material" items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements" (paragraph 17).

7 The Committee also notes paragraphs 3 to 7 of the Statement on Standard Auditing Practices (SAP) 13, 'Audit Materiality', issued by the Institute of Chartered Accountants of India, which state as below:

"3. 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.

4. The objective of an audit of financial information prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is material is a matter of professional judgement.
5. The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which 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.
6. Although the auditor ordinarily establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.
7. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedure could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be."

8 From the above, the Committee is of the view that though 'accrual' is one of the fundamental accounting assumptions, the materiality threshold is applicable to this accounting assumption also. If an information is immaterial on the consideration of materiality as mentioned in paragraphs 6 and 7 above, its accounting treatment would not have any effect on the decisions of the users of the financial statements. This view is also supported by the Preface to the Statements of Accounting Standards, issued by the Institute of Chartered Accountants of India, which states that "Accounting Standards are intended to apply only to items which are material" (paragraph 4.3). Accordingly, it needs to be ascertained under the facts and circumstances of the company concerned as to whether the amount of Rs. 25,000 would be material or not in respect of each item, or in the aggregate and that would provide the basis for its accounting treatment.

9 The Committee is also of the view that materiality needs to be determined under the specific facts and circumstances of each company keeping in view as to how it affects the financial statements either individually or in the aggregate. Accordingly, levels of materiality may be different in different companies. Also, since the assessment of what is material is a matter of professional judgement, it is possible that different professionals may reach different conclusions.

D. Opinion

10 On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5:

(a) The appropriateness of the accounting policy of the company as stated in paragraph 2 above, would depend upon the considerations of materiality determined on the basis of paragraphs 6 and 7 above. Accordingly, the accounting policy in question would be proper provided it does not cross the threshold of materiality.

(b) Since the levels of materiality may be different in different companies keeping in view their individual facts and circumstances, the auditors may reach different conclusions. Also, since the assessment of what is material is a matter of professional judgement, different professionals may reach different conclusions. ■