Standards on Auditing

320 - Materiality in Planning and Performing an audit.

450 - Evaluation of misstatement identified during the audit.

CA. Nimesh Bhimani

SA 320 – Materiality in Planning and Performing an audit

- Information is material if its misstatement (i.e. omission or erroneous statement) could influence the economic decision of uses on the basis of financial information.
- Judgment about Materiality depends on size and nature of item, judged in the particular circumstances of its misstatement. Thus it provides the cutoff point.
- The concept of materiality recognizes some matters either individually or in the aggregate.

- Auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transaction.
- Materiality also be influenced by other considerations, such as legal and regulatory requirements, non-compliances with which may have a significant bearing on the financial information and consideration relating to individual account balances and relationships.
- The auditor needs to consider the possibility of misstatement of relatively small amount, cumulatively could have material effect on the financial information .e.g. month end or periodic error which is repetitive.

Relationship between materiality & audit risk

- The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement; at the time of evaluating the result. Hence, assessment of materiality and audit risk may also change.
- There is an inverse relationship between materiality and the degree of audit risk. Higher the materiality level, the lower the audit risk and vice versa .e.g. The risk of particular account balance or classes of transaction could be misstated by extremely large amount might be very low. But the risk of misstated extremely small amount might be very high.

Different Types of Materiality

Types of Materiality	Calculation	Significance
Materiality	% of chosen benchmark (Sales, Net Profit, Net Worth, etc.) Example : Net Profit of X Ltd = Rs.20 crores. Materiality = 5% of NP = 5% of 20 crores = Rs. 1crore	The maximum tolerable misstatement amount which will not affect the decision of the users of financial statements.
Performance Materiality	Performance Materiality = 75% of Materiality = Rs. 75lacs	The amount chosen by the auditor in planning and performing the audit.

Use of Benchmark in determining materiality for the financial statement as a whole

- Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining for the financial statement as a whole.

- Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

- In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditures less receipts) may be appropriate benchmarks for that particular program/activity. Where an entity has custody of the assets, assets may be an appropriate

Performance Materiality

- Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstated, and leaves no margin for possible undetected misstatements.
- Performance materiality is set to reduced to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statement as a whole.

Revision as the audit progresses.

- Part 1: Revise Materiality if auditor becomes aware of information during audit:
  - That would have caused him to have determined a different amount of initially

- Part 2: If materiality level requires lowering , determine:
  - Need to revise performance materiality
  - Appropriateness of nature, Timing to extend (NTE) of further audit procedures.

- Part 3 : Materiality may need to be revised as a result of :
  - A change in circumstances that occurred during the audit for example , a decision to dispose of a major part of the entity's business.
  - New information
  - A change in auditor's understanding of entity and its operation as a result of performing further audit procedure
  - For example, if during . audit it appears as though actual financial results are likely to be substantially different from anticipated period end financial results that were used initially as to determine materiality for Financial Statements as a whole, auditor revises that materiality

Scope of SA 320 & SA 450

This SA 320 Deals with

Auditors Responsibility

Apply the concept of materiality

In planning & performing audit of FS

SA 450 Explains

Application of materiality

Evaluating effect of

- Identified misstatement on audit procedures
- Uncorrected misstatements on FS

SA 450 Evaluation of misstatement identified during the audit

- It should be read in contract of the "preface to the standard to the Quality Control, Auditing Review, Other Assurances and Related Services". – Revised SA 200 and SA700.

To Evaluate

Effect of identified misstatements on audit (audit procedures)

Effect of uncorrected misstatements (if any) on FS.

SA 450- Evaluation of misstatement Identified during audit

Audit Process	• Basic Flow of the Audit Process
Correction of Misstatements	• Communication & Correction of Misstatements
Communication with TCWG	• Request correction of uncorrected misstatements
Written Representation	• From Mgt that effect of uncorrected misstatements are immaterial
Documentation	• All misstatements accumulated during the audit and whether they have been corrected.

- Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or a disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

- Uncorrected misstatement – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Effect of identified misstatements as the audit progresses

- The auditor shall determine whether the overall audit strategy and audit plan need to be revised.
- The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatement may exist that, when aggregated with misstatements accumulated during the audit , could be material or materiality determined as per S.A.320.
- If, at auditor's request management has examined a class of transactions, account balances or disclosure and corrected misstatement that were detected, the auditor shall perform additional audit procedures to determine whether misstatement remains.

Evaluate the effect of uncorrected misstatements

- Auditor shall reassess materiality determined in accordance with S.A. 320 to confirm whether it remains appropriate in the context of financial result.
- The size and nature of misstatements , both in relation to particular classes of transactions, account balances or disclosures and the financial statement as whole and in particular circumstances of their occurrence and
- The effect of uncorrected misstatement related to prior period on the related to prior period on the relevant classes of transactions, account balances & disclosures, and the financial statement as a whole.

Communication with those charged with Governance

- Communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation
- If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections

Written representation

- Audit should request written representation from management the effect of uncorrected misstatement are immaterial individually or in aggregate to financial statement as Misstatement may result from:-

➢ In accuracy in gathering or processing financial data.

➢ Omission of an amount or disclosure.

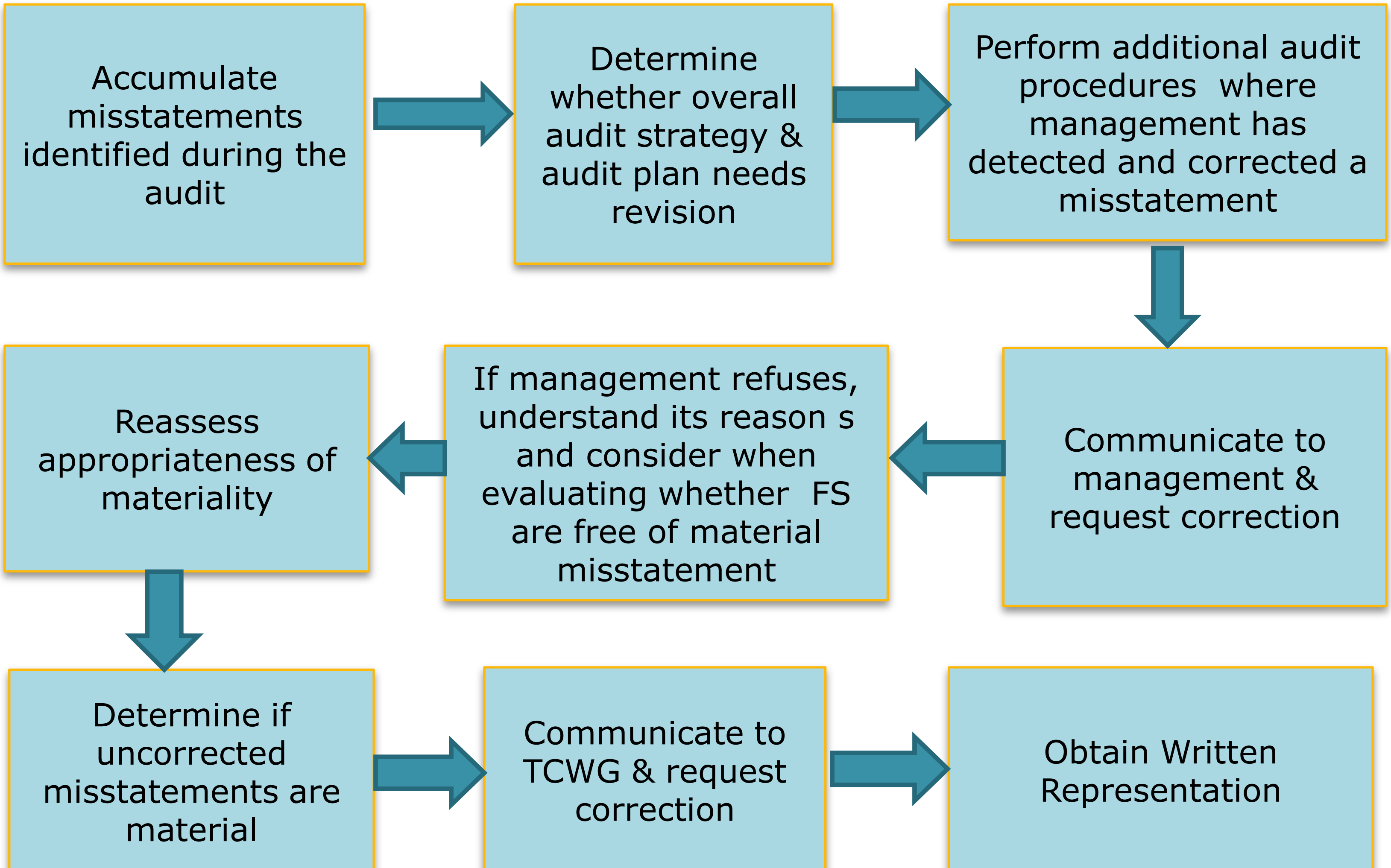
➢ Incorrect accounting estimates arising from overlooking or clear misinterpretation of facts.

➢ Selection and application of accounting policies which are inappropriate.

Documentation

- The audit documentation shall include:
  - The amount below which misstatements would be regarded as clearly trivial;
  - All misstatements accumulated during the audit and whether they have been corrected and
  - The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

Basic Flow of the Audit Process



THANK YOU