SA 320 – MATERIALITY IN PLANNING AND PERFORMANCE OF AN AUDIT

CONCEPT OF MATERIALITY

1. 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.
2. Materiality is **not always a matter of relative size**.
3. In certain cases, **quantitative limits of materiality is specified**. A few of such cases are given below:
   a. A company should **disclose by way of notes additional information** regarding any item of **income or expenditure which exceeds 1% of the revenue from operations or Rs.1,00,000 whichever is higher** (Schedule III to the Companies Act, 2013).
   b. A company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 % shares specifying the number of shares held.
4. Standard on Auditing (SA) -320 on "Materiality in Planning and Performing an Audit" deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450 explains **how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements** on the financial statements.
5. **MATERIALITY IF FRFW DO NOT CONTAIN ANY REFERENCE THERETO:** Financial reporting frameworks **often discuss the concept of materiality in the context of the preparation and presentation of financial statements**. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
   a. Misstatements a**re material if expected to influence the economic decisions of users** taken on the basis of the financial statements.
   b. Judgments about **materiality are affected by the size or nature of a misstatement** or combination of both.
   c. Judgments about matters that are material are **based on a consideration of the common financial information needs of users** as a group. The **possible effect of misstatements on specific individual users**, whose needs **may vary widely, is not considered**.

If the applicable financial reporting framework **does not include a discussion of the concept of materiality, the characteristics referred above** provide the auditor with such a frame of reference.

DETERMINATION OF MATERIALITY IS A MATTER OF PROFESSIONAL JUDGMENT OF AUDITOR

The **auditor's determination of materiality is a matter of professional judgment**, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is **reasonable for the auditor to assume that** users:

1. Have a reasonable knowledge of business and economic activities and accounting and **a willingness to study the information in the financial statements** with reasonable diligence.
2. **Understand that financial statements are prepared, presented and audited** to levels of materiality.
3. **Recognize the uncertainties inherent in the measurement** of amounts based on the use of estimates, judgment and the consideration of future events and
4. Make **reasonable economic decisions on the basis of the information** in the financial statements.

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, ON THE FINANCIAL STATEMENTS AND IN FORMING THE OPINION IN THE AUDITOR'S REPORT

1. **Materiality is an important consideration** for an auditor to evaluate whether the **financial statements reflect a true and fair view or not.**
2. SA 320 on "Materiality in Planning and Performing an Audit" requires **that an auditor should consider materiality and its relationship with audit risk** while conducting an audit.
3. When planning the audit, the auditor considers **what would make the financial information materially misstated.**
4. The **auditor's preliminary assessment of materiality** related to specific account balances and classes of transactions **helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures**.
5. This enables the **auditor to select audit procedures** that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk.

6. It may be noted that the **auditor's assessment of materiality and audit risk may be different at the time of initially planning** of the audit **as against at the time of evaluating the results of audit procedures**.
7. At the planning stage, the auditor needs **to consider the materiality for the financial statements as a whole.** The auditor has to carry out a preliminary identification of significant components and material classes of transactions, account balances and disclosure which he plans to examine.
8. What could be considered material for all situations cannot be defined precisely and **an amount or transaction material in one situation may not be material in other situation**.
9. The auditor **has to apply his professional judgement in determining materiality,** choosing appropriate benchmark and determining level of benchmark.
10. Materiality forms the **basis for determination of audit scope and the levels of testing the transactions.**
11. **If there is any statutory requirement of disclosure, it is to be considered material** irrespective of the value of amount.

PERFORMANCE MATERIALITY

1. When **establishing the overall audit strategy, the auditor shall determine materiality** for the financial statements as a whole.
2. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which **misstatements of lesser amounts than the materiality** for the financial statements as a whole, **could reasonably be expected to influence the economic decisions of users** taken on the basis of the financial statements, **the auditor shall also determine** the materiality level or levels **to be applied to those particular classes** of transactions, account balances or disclosures.
3. **PERFORMANCE MATERIALITY:** Performance materiality **means 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.

   If applicable, **performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level** or levels for particular classes of transactions, account balances or disclosures.

USE OF BENCHMARKS IN DETERMINING MATERIALITY FOR THE FINANCIAL STATEMENTS 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 materiality** for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

1. The **elements of the financial statements**.
2. Whether there are items on which **the attention of the users** of the particular entity's financial statements **tends to be focused**
3. 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
4. The **entity's ownership structure** and the way it is financed
5. The **relative volatility of the benchmark**.

BENCHMARKS THAT HELPS IN DETERMINGING MATERIALITY

SELECTION OF CHOOSEN BENCHMARK: In relation to the chosen benchmark, relevant financial data ordinarily includes:

1. **Prior periods' financial results** and financial positions,
2. The **period to-date financial results** and financial position, and
3. **Budgets or forecasts** for the current period,

Adjusted for significant changes in the circumstances of the entity and relevant changes of conditions in the industry or economic environment in which the entity operates.

APPLY A PERCENTAGE ON CHOOSEN BENCHMARK: Determining a percentage to be applied to a chosen benchmark **involves the exercise of professional judgment.** There is a **relationship between the percentage and the chosen benchmark,** such that a **percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue**.

MATERIALITY LEVEL OR LEVELS FOR PARTICULAR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES OR DISCLOSURES

Factors that **may indicate the existence of one or more particular classes of transactions**, account balances or disclosures for **which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions** of users taken on the basis of the financial statements include the following:

1. Whether law, regulations or the applicable financial reporting framework **affect users' expectations regarding the measurement or disclosure** of certain items.
2. The **key disclosures in relation to the industry** in which the entity operates.
3. Whether **attention is focused on a particular aspect of the entity's business** that is separately disclosed in the financial statements.

REVISION AND DOCUMENTATION OF MATERIALITY

REVISION IN MATERIALITY LEVEL:

The overall materiality and performance materiality may need to be changed as the audit progresses in the following cases:

1. A **change in circumstances that occurred during the audit**.
2. Availability of **additional information**.
3. A **change in actual financial results than the anticipated results** at the beginning of the audit.
4. **Increase in estimated risk** than the original prediction resulting in revision of materiality level.
5. A **change in auditor's knowledge of client's business** and understanding of the same.

DOCUMENTATION OF MATERIALITY:

The auditor shall document the following:

1. **Materiality for the financial statements as a whole** (Overall materiality);
2. If applicable, **the materiality level or levels for particular classes of transactions**, account balances or disclosures;
3. General **Performance materiality**; and
4. **Any revision** of the above.