Materiality in Planning and Performing the Audit : SA 320

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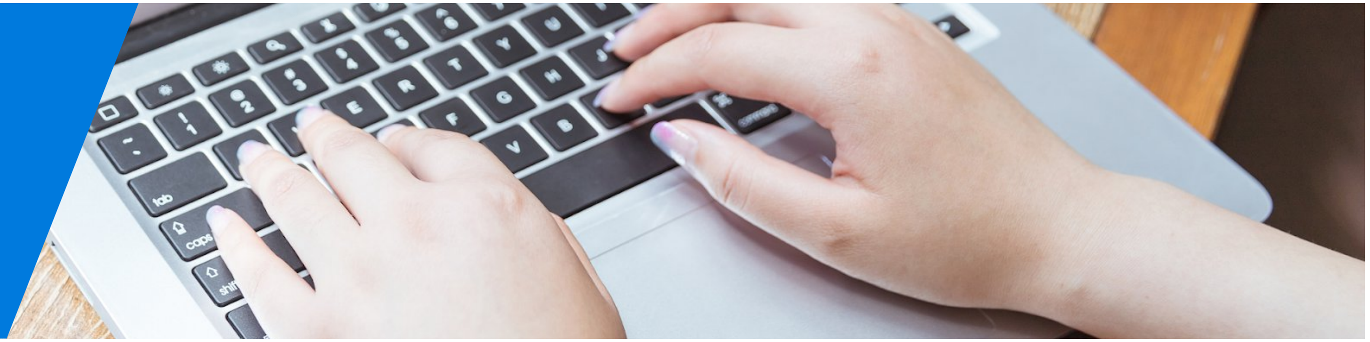
1 June 2024



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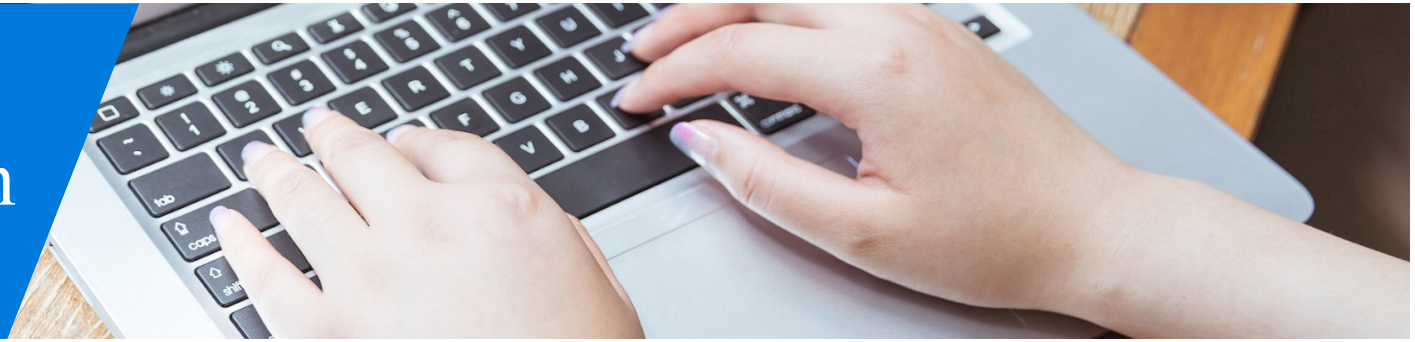
Introduction

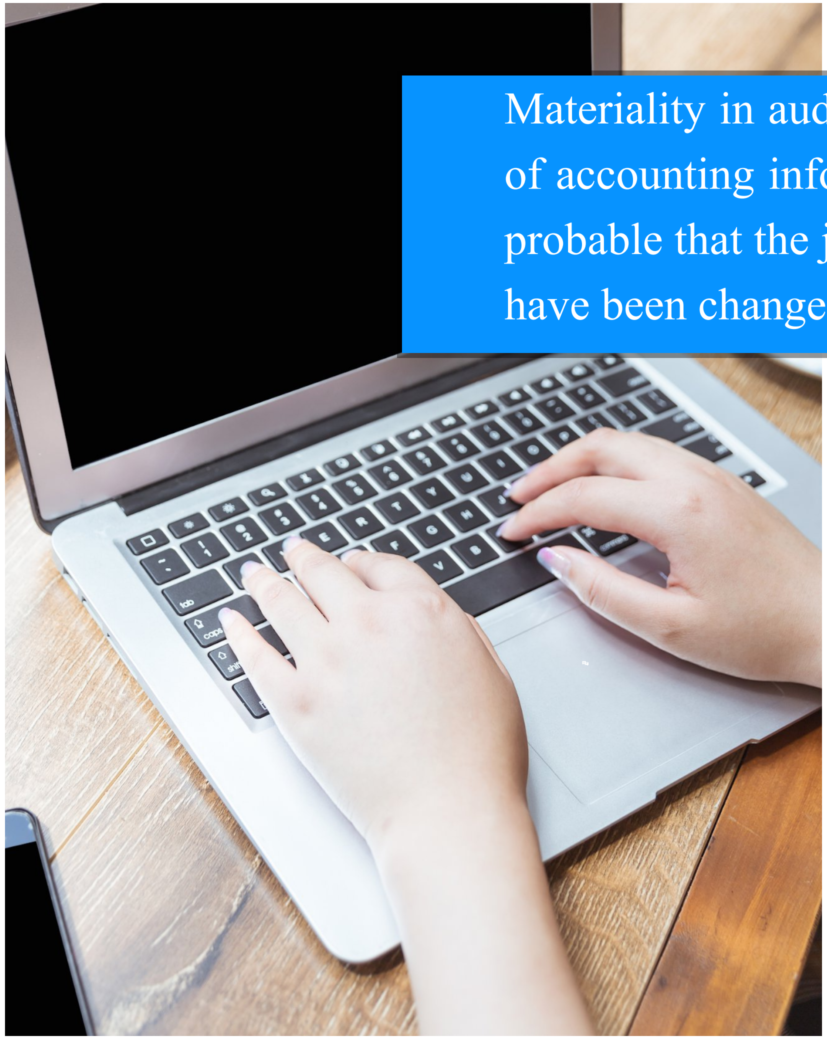


As per SA 320, when establishing the overall audit strategy, **an auditor determines materiality** for the financial statements **as a whole.** If, in the specific circumstances of the entity, there is **one or more particular classes of transactions, account balances or disclosures** for which **misstatements of lesser amounts than 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 would also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Audit materiality plays a pivotal role in the auditing landscape, influencing the scope and depth of examination. Audit materiality represents the threshold beyond which misstatements, errors, or omissions in our financial information could impact the judgment of users relying on entities financial statements. **Striking the right balance in defining materiality is paramount; it guides the auditors in focusing on issues that are significant to the stakeholders while avoiding undue emphasis on immaterial matters.**

In this presentation we will discuss the concept of materiality, how is it determined and how does it impact the audit of the financial statements.

Definition of Materiality and its Relationship with Audit process



Materiality in auditing is defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

The concept of materiality is fundamental to the audit process. It is applied by the auditor for :

Risk Assessment.

Determining the nature, time and extent of audit procedures To gather sufficient and appropriate audit evidence.

Evaluating the effect of identified and uncorrected Misstatements on the financial statements.

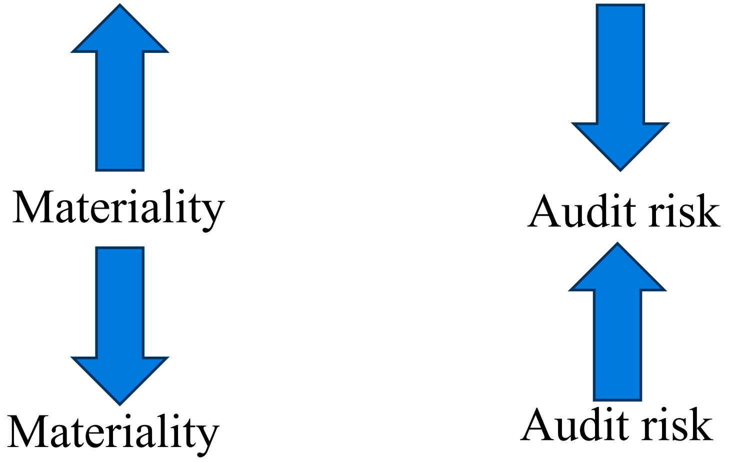
Forming the audit opinion and report.

Materiality and Audit Risk

- Audit Risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
- Audit risk is a function of the risk of material misstatement and detection risk.
- Materiality and audit risk are considered throughout the audit, in particular when:
  - Identifying and assessing the risk of material misstatement,
  - Determining the nature, timing and extent of audit procedures; and
  - Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Inverse Relationship

There is an inverse relationship between materiality and audit risk



Types of Materiality

Overall Materiality/ Materiality/ Total Materiality	• Overall materiality is a threshold above which the financial statements could be misstated and would affect the economic decision of the user of the financial statements It depends on the size of the organization, nature of industry/ sector, types of transactions and balances, risk profile of the client and engagement, past history of unadjusted and adjusted audit misstatements, internal control environment and auditor's judgement.	**INR 100**
Performance Materiality	• Performance materiality it is an amount less than overall materiality. It acts as a safety buffer to lower the risk of aggregate uncorrected and undetected misstatements which could be material for overall financial statements. Performance Materiality is lower than Overall materiality since it addresses aggregation risk.	**INR 75**
Audit difference posting threshold/ Specific Materiality	• Specific materiality it is established for class of transactions, account balances and disclosures. It is calculated as 5% of the overall materiality. The specific materiality threshold is using to accumulate audit differences. Audit differences less than threshold are ignored at a workpaper level.	**INR 5**

Determining the Materiality

For determining the overall materiality, following steps are involved

Selecting the appropriate benchmark and financial data for the selected benchmark.

Determining the percentage to be applied to the selected benchmark depending upon the risk assessment.

Determining Appropriate Benchmark

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

- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue, net assets or related party transactions);
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- 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
- The relative volatility of the benchmark.

Determining Appropriate Benchmark *(continued)*

Below are examples of how these consideration may indicate what is important to the users:

Consideration	**What is important to the users?**	**Example of a metric that may be relevant**
Profit-seeking entity	The entity's profitability and prospects for future net cash inflows.	PBTCO/ Average PBTCO/ Weighted average PBTOC/ Loss before Tax
A highly leveraged entity	The entity's ability to service its debt, including the ability to satisfy obligations and comply with debt covenants and continue as a going concern.	Net Assets
An entity in an industry where margins can fluctuate significantly (e.g. a start-up enterprise)	The sales base that would drive future profitability and cash flows.	Total Revenues
An entity primarily generating profit from lending activities (e.g. a Bank or FI)	The asset base that drives lending activities - i.e. the primary profit generating activities.	Total Assets
An entity operating on cost plus markup (Captive subsidiaries)	Profitability depends on Total expenses of the company.	Total Expenses

Determining Appropriate Benchmark *(continued)*

- There is no professional standard that states how much amount or percentage auditors should use for calculation of materiality.
- However, there is a rule of thumb that auditors on the basis of their professional judgment need to decide the level of materiality in audit. Below is the illustrative table which suggest the range of overall materiality:

Gross benchmark	Illustrative Percentage
Total revenue	0.5%–2.0%
Total assets	0.5%–2.0%
Total Expenses	0.5%–2.0%
Net benchmark	**Illustrative Percentage**
Profit before tax from continuing operations	3%-8%
Net assets	3%-8%

Illustration:

Illustration 1:
Entity D is a listed entity that leases high value machinery to the construction industry.
The entity has been an audit client for a number of years and the engagement risk has been determined as normal.
The entity has very little external debt and finances most investments by internally generated funds.
The entity has a history of few identified misstatements, and the engagement team has assessed its internal control as effective.
There have been no significant changes in the entity's business, management or internal control during the period.
What shall be benchmark to be considered for calculating materiality??

A. Total Revenues
B. PBTCO/LBTCO
C. Net Assets
D. Total Expenses

Conclusion :
The audit team may consider either PBTCO or Net Assets as the most appropriate benchmark in determining materiality.

Illustration:

Illustration 2:

There is an E-commerce Company which provides a platform where customers can purchase gold and sell gold and the company's margin is the difference at which gold is purchased from Dealers and sold to customers on the platform and gold sold by customers on the platform and re-sold to dealers. The Company is earning normal operating margins. Overall there is Loss before taxes in the financial statements. So what shall be benchmark to be considered for calculating materiality?

A. PBTCO/LBTCO
B. Total Expenses
C. Total Revenues
D. Net Assets

Conclusion :

Since the company strategy helps to earn normal operating margin throughout the year**,** therefore the auditor should consider **PBTCO/LBTCO** as most appropriate benchmark in determining materiality.

Illustration:

Illustration 3:

An IT entity has been in business for five years. It develops software products and provides related implementation and maintenance services.

In prior periods, the entity focused on software development. So, it capitalized significant development costs and operating expenses, with no significant sources of revenue. Accordingly, the engagement team determined that revenue and earnings (PBTCO) were not as important to the users at this stage of the entity's life cycle. Also, while total assets, net assets and total expenses have been important to the users, the most relevant benchmark has been total assets.

In the current period, the entity has begun to generate significant revenues in both segments but continues to operate at a loss.

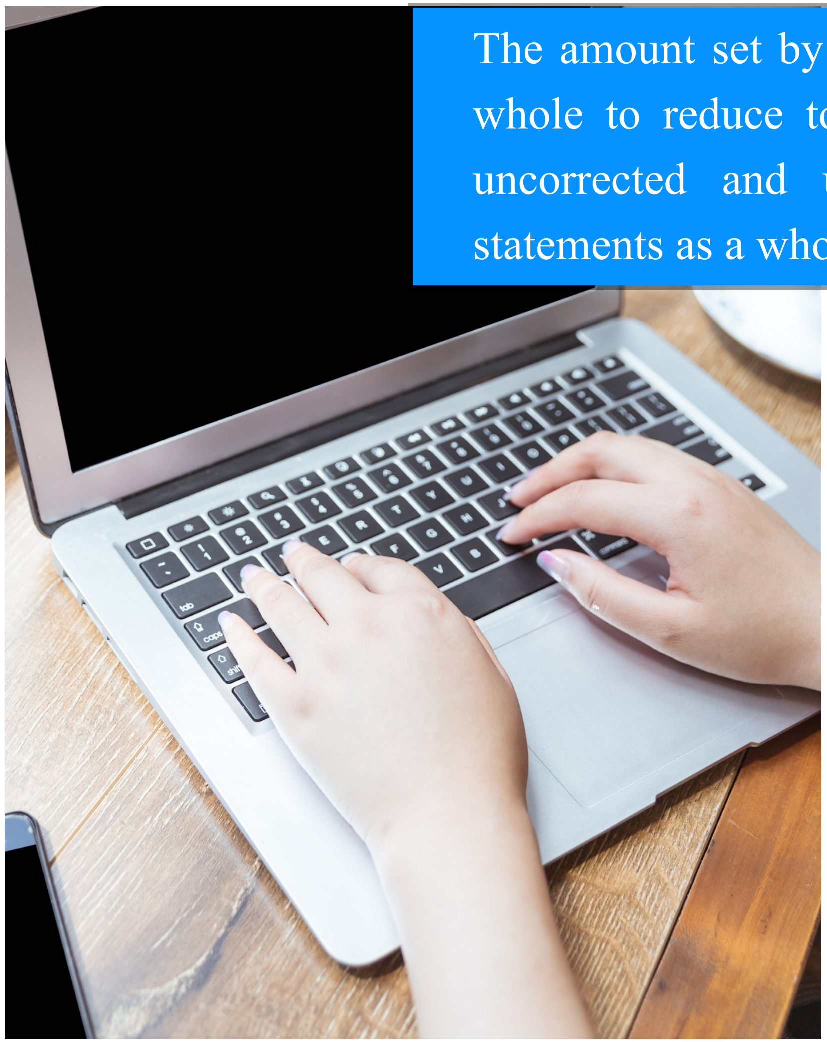
What will be relevant benchmark in the current period?

A. Total Revenues
B. PBTCO/LBTCO
C. Net Assets
D. Total Expenses

Conclusion :

Since in the current period, the entity has begun to generate significant revenues**,** therefore the auditor should consider **total revenue** as most appropriate benchmark in determining materiality.

Performance Materiality



The amount 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.

- The performance materiality aims to reduce the impact of materiality.
  It uses a lower threshold that enables auditors to identify more misstatements.
- Performance materiality aims to reduce the aggregate impact of several smaller errors and misstatements (**aggregation risk**).
- <u>Performance materiality is the basis on which the engagement would perform substantive sampling based on monetary unit sampling (MUS).</u>

Performance Materiality *(continued)*

- Setting the performance materiality is a judgmental matter and is affected by an auditor's understanding of the entity specific risk assessment factors like :
  - Whether this is the first year of the audit – use lower performance materiality
  - Deficiencies in entity-level controls
  - Number and severity of deficiencies in control activities including pervasiveness of internal control deficiencies,
  - History of misstatements that were accumulated in the audit of the financial statements of prior periods (both corrected and uncorrected),
  - Level of turnover of senior management or key financial reporting personnel,
  - Management's preparedness/willingness to correct misstatements, etc.
- Depending on the extent to which these risk assessment factors apply, performance materiality could be determined to be in the range of 75 to 50 per cent of the materiality amount. Range of performance materiality depends on level of aggregation risk as shown below:

When aggregation Risk is assessed as:	Performance materiality is determined as:
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

Specific Materiality/ Audit Difference Posting Threshold:

It is calculated as 5% of the overall materiality.

Illustration:

Illustration 4:

AB Pvt. Ltd. Is a company engaged in providing support services to its holding company located in US. The profit margin of the company is based on total cost plus 5% of the margin. Some details from projected financials are given below:

Total Revenue: 25,00,00,000

Total Expenses: 20,00,00,000

Net Profit: 1,00,00,000

Net Assets: 50,00,00,000

Determine materiality, Performance materiality and Specific materiality?

Conclusion:

Since the company profit model is based on total cost therefore benchmark for the purpose of materiality will be **Total expenses**.

Materiality

Based of auditor's professional judgement materiality will me in in range of 0.5% to 2% of benchmark (we have considered 2%) i.e., 20,00,00,000*2 = 40,00,000. Therefore, materiality is 40,00,000.

Performance Materiality

A common rule of thumb is to calculate performance materiality/tolerable misstatement as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. Usually, 75% of Planning materiality is considered for Performance materiality. Therefore, Performance Materiality is 75% of 40,00,000 = 30,00,000.

Specific Materiality

An amount below which detected misstatements need not be accumulated on the summary of audit differences (sometimes referred to as and specific materiality, or adjustments passed at the workpaper level). Specific materiality is 5% of materiality which is 5% of 40,00,000 = 2,00,000.

Group versus component materiality

Group Materiality

- Group materiality is the materiality level set for the financial statements as a whole, typically at the consolidated level.
- It considers the aggregate financial performance and position of the entire reporting entity, which may consist of multiple subsidiaries, divisions, or business units.
- Group materiality helps in assessing the overall significance of misstatements or omissions in the consolidated financial statements.
- As the group engagement team, we establish group materiality in the same way as in a stand-alone audit, but consider the amounts of metrics from the consolidated financial statements.

Component Materiality

- Component materiality is the materiality level set for individual components within the group, such as subsidiaries, divisions, or business units.
- It focuses on the materiality of each component's financial information within the context of the consolidated financial statements.
- Component materiality is used to evaluate the significance of misstatements or omissions within the financial statements of individual components, considering their contribution to the overall group financials.

Group versus Component Materiality *(continued)*

Allocation of component materiality

- Each Component should receive an allocation of materiality that is less than group overall materiality.
- For that benchmark is identified that best represents the size of each component relative to the group in order to determine its relative size. It can be either total revenue or total assets or total expenses.
- The aggregate component materiality for the largest components is generally kept within the benchmark multiple for that number of components.

Exhibit 2 Benchmark Multiples

Number of significant components to which MACM will be allocated	Multiple applied to group overall materiality to determine maximum aggregate component materiality (MACM)
2	1.5
3–4	2.0
5–6	2.5
7–9	3.0
10–14	3.5
15–19	4.0
20–25	4.5
26–30	5.0
31–40	5.5
41–50	6.0
51–64	6.5
65–80	7.0
81–94	7.5
95–110	8.0
111–130	8.5
131+	9.0

Group versus Component Materiality *(continued)*

Illustration

- AB is a holding company which is engaged in providing software support service and has two subsidiaries A and B. Group materiality is calculated using total expenses as benchmark since company follow cost plus markup approach which was Rs. 27,00,000.
- Total expenses of A and B are Rs. 25,00,00,000 and 2,00,00,000 respectively.

Calculate materiality of both the components.

Conclusion:

In the given case, since number of significant components are two, thus benchmark multiple to group overall materiality is 1.5.

Therefore, allocated component materiality will be 1.5 * 27,00,000 = 40,50,000.

Allocated component materiality is to be to allocated to components on the basis of proportion of expenses since total expenses is considered as a benchmark.

Company	Expenses	Proportion of expenses	Overall Materiality	Performance Materiality (75% of Overall Materiality)	Specific Materiality (5% of Overall Materiality)
A	25,00,00,000	93%	37,50,000	28,12,500	1,87,500
B	2,00,00,000	7%	3,00,000	2,25,000	15,000
Total	**27,00,00,000**	**100%**	**40,50,000**	**30,37,500**	**2,02,500**

Quiz

Question 1:

Q. Which of the following is not an example of benchmarks in determining materiality for the Financial Statement as whole?

a) Profit before tax
b) Total Revenue
c) Total Liabilities
d) Total Equity/Net Assets

Answer 1:

Q. Which of the following is not an example of benchmarks in determining materiality for the Financial Statement as whole?

Ans. **Total Liabilities**

Quiz Time

Question 2:

Q. In cases where there are no directly comparable benchmarks available, auditors may ____________________.

a) Use benchmarks from a different industry
b) Skip the materiality assessment
c) Rely solely on the company's historical performance
d) Refuse the audit engagement

Quiz Time

Answer 2:

Ans. In cases where there are no directly comparable benchmarks available, auditors may **use benchmarks from a different industry**.

Quiz Time

Question 3:

Q. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of ____________________.

a) Independence
b) Professional Judgement
c) Professional skepticism
d) Professional behavior

Answer 3:

Ans. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of **Professional Judgement**.

Question 4 :

Q. ____________ means the amount set by the auditor at less than materiality for the financial statement as whole to reduce to an appropriate low level of probability that the aggregate of uncorrected and undetected misstatement exceeds materiality for the financial statements as a whole.

a) Benchmark materiality
b) Materiality in planning
c) Performance materiality
d) Materiality

Answer 4:

Ans. **Performance materiality** means the amount set by the auditor at less than materiality for the financial statement as whole to reduce to an appropriate low level of probability that the aggregate of uncorrected and undected misstatement exceeds materiality for the financial statements as a whole.

Question 5 :

Q. What role does the auditor's professional judgment play in the determination of performance materiality?

a) Professional judgment is not relevant in setting performance materiality
b) Professional judgment is the sole factor in setting performance materiality
c) Professional judgment complements quantitative factors in setting performance materiality
d) Professional judgment is only considered in financial reporting, not in auditing

Answer 5 :

Q. What role does the auditor's professional judgment play in the determination of performance materiality?

Ans. Professional judgment complements quantitative factors in setting performance materiality.

Thank You

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