

## Materiality in Planning & performing an audit

⑧ Meaning of materiality (as per FRF).

FRF may discuss materiality in diff<sup>r</sup> terms, it may include the following:

definition

(a) MS including omissions, are considered as material, if they individually or when aggregated, could reasonably be expected to influence the economic decisions of users taken on the basis of FS.

(b) Judgement about materiality is affected by size or nature of MS (or) or a combination of both.

(c) The possible effect of MS on specific individual user whose needs may vary is not considered while determining materiality because materiality is based upon common FI needs of users as a group.

(b) why materiality. ⇒ Because of overall objective of SA 200.

(c)

9

Materiality in planning & performing an audit -  
Auditor Responsibility.

NOV 23



note 7.1) Determination of materiality - a matter of professional judgement  
In the context of materiality, it is reasonable for the auditor to assume that the users:

- (a) users have a reasonable knowledge of entity's business & its economic activities, they are also willing to study the info<sup>o</sup> included in FS with reasonable diligence.
- (b) <sup>users should</sup> Understand the FS are prepared, presented & audited to levels of materiality
- (c) <sup>users should</sup> Recognise the uncertainties <sup>while</sup> inherent in the measurement of the amounts based on the use of estimates, judgement & the consideration of future events &
- (d) <sup>users should</sup> Make reasonable economic decisions on the basis of the info<sup>o</sup> in the FS.

Performance Materiality ☆ ☆ ☆ ☆ ☆ ☆ ☆ ☆ ☆ ☆

(detected but not corrected)

- (a) Performance materiality <sup>or</sup> means the amount or amounts set by the auditor at less than the materiality for overall FS level to reduce the risk i.e. probability that the aggregate of uncorrected & undetected MS may exceeds the FS level materiality
- (b) It also refers to amount or amounts set by the auditor at less than the materiality level or levels for particular ABCD.
- (c) It is set at a value lower than overall materiality. It will lower the risk that auditor will not be able to detect certain MS which may become material when aggregated [helps to reduce detection risk].

## Determining Materiality & Performance Materiality when planning the audit

→ may 23.

### Use of Benchmarks in Determining materiality for the FS as a whole

- Examples of Benchmark :-  
Profit Before tax, Gross revenue or T/O, Gross Profit & total expense, Total equity & Net Asset value.
  
- Factors may affect identification of an appropriate benchmark
  - (i) Volatility involved in the benchmark [eg- company does not have consistent profitability over a period of last 5 years.]
  - (ii) The elements of FS such as revenue, expenses, equity, assets & liabilities. etc.
  - (iii) Entity ownership structure & the way it is financed.
  - (iv) Nature of entity's business, industry in which entity operates, stage of product life cycle etc.
  - (v) ~~other~~ other factors such as FS items which may require attention of its users. Such as In a startup world no. of new customer acquired by spending money is an important factor.

5  
Benchmark in materiality.

↳ examples of factors effective the identification of benchmark.

Page No.:

PANKAJ

Date: / /

Choose-Benchmark — Relevant financial data

[Relevant financial data that should be considered after choosing an appropriate benchmark]

- Current Period financial data for period to date number
- Budgets or forecasts for the current period.
- Prior Period financial data or results
- If any adjustment is required because of <sup>significant</sup> changes in ~~significant~~ conditions of the industry or subsequent events

NOV 20

Determining a % to be applied to a chosen benchmark involves the exercise of professional judgement :->

Generally, 5% of PBT from continuing operations for a profit oriented entity is appropriate in many industry. However, if the profit amount is <sup>keep changing</sup> volatile then total revenue or total expenses depending upon the entity nature can be used as a benchmark. & 1% of total revenue can be defined as materiality level.

Materiality Level or Levels for Particular classes of tx<sup>n</sup>

1) bal or disclosures (ABC'D) :->

o: Materiality depends on following factors :->

- The amount involved or size of an item of FS [for normal business tx<sup>n</sup>]
- Nature of tx<sup>n</sup> [lawyer fees]
- Applicable L or R or PRF affecting certain items of FS [eg. Managerial remuneration as per Companies Act, TDS, compliances etc.]
- Any other key disclosures required in the industry [such as RBI norms for banking cos.].

Is materiality a matter of size?

(c) Any other factor which may require focus on a particular aspect of entity's business such as newly acquired business or recently divested segment.

### Revision in materiality level as the audit progresses

(a) Materiality in audit may need to be revised as a result of change in circumstances, availability of new info<sup>n</sup> or due to change in auditor's understanding of the entity as result of performing FAP.

(b) eg<sup>n</sup> If during the course of audit, actual financial result such as profit before tax (PBT) seems to be substantially different from the original anticipated amount which was considered for calculating materiality during planning then auditor may need to revise their materiality.

### Documenting the materiality

The auditor shall document the following amounts & factors that were used in their determination:

- (a) materiality for FS as a whole,
- (b) If applicable material level or levels for ABED (ie performance materiality) &
- (c) Any revision in the above amount when the audit progresses.

Materiality & Audit Risk →

- (a) Materiality is applied by the auditor both in planning & performing the audit & in evaluating the effects of identified uncorrected MS on his audit opinion.
- (b) Audit risk is the risk that auditor may express an inappropriate opinion when the FS are material misstated.
- (c) Audit risk is a function of RMM & DR.
- (d) Maintain overall objective as per SA 200.
- (e) Both materiality & audit risk should be considered throughout the audit in particular, when:
  - (i) In identifying & assessing RMM through RAP.
  - (ii) In determining NTE of FAP.
  - (iii) Evaluating the effects of uncorrected misstatements.