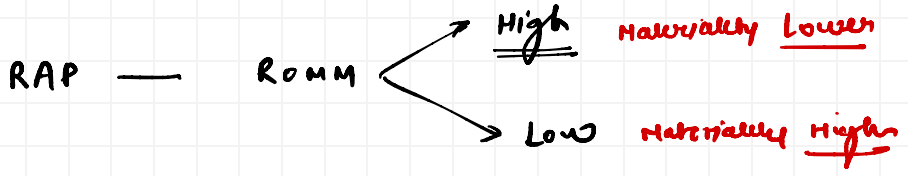


A → Benchmark → % age

PAT / PBT / Revenue / Value of Asset

Revenue = 100 crore [1%] = 1 crore

Profit = 30 crore [5%] =



A

ROMM ↑

checking - Extent High

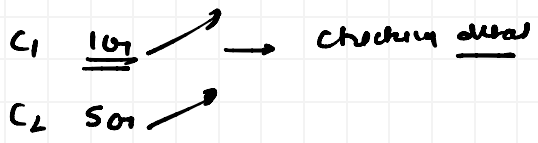
Materiality ↓

B

ROMM ↓

checking - Extent Low

Materiality ↑



Materiality

SA 320 - Materiality in Planning/Performing
an Audit

A's Responsibility to Apply Concept of
Materiality in P/P - Audit

X materiality is a concept in auditing that relates to the significance
of transactions, balances, or errors. It is the threshold above
which misstatements or omissions could influence the economic
decisions of users taken based on the financial statements. X

o FRF - Discusses - Materiality in Context
of PPFs

o Auditor can use the Reference in FRF
in determining level of materiality

Generally FRF explain Materiality as follows

1) Mistatement including omissions can be considered material, if they Individually or in Aggregate could Reasonably be expected to influence the Economic decisions of user taken on the basis of FS.

2) Judgement Regarding Materiality are affected by — Surrounding Circumstances
— Size
— Nature

3) Judgement Regarding Materiality of a Matter is also dependent on — Common financial information need of the users as a Group

Application of concept of materiality

Planning and performing the audit and evaluating the effect of misstatements on audit and financial statements

materiality is not always a matter of relative size

A small loss due to employee fraud can indicate a serious flaw in the enterprise's internal control system, requiring immediate attention to prevent greater future losses

The materiality threshold set during audit planning does not mean that all misstatements below this threshold are immaterial.

If there is a statutory requirement for disclosure, it must be considered material regardless of the amount

Division I of Schedule III of Companies Act, 2013: Disclose any income or expenditure item exceeding 1% of revenue from operations or ₹1,00,000, whichever is higher.

Disclose in notes to accounts the shares held by each shareholder owning more than 5%, specifying the number of shares, as per Division I of Schedule III of Companies Act, 2013.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material.

Judgement, about size of misstatement that will be considered material will help the auditor in

- Determining the nature extent and timing of risk assessment procedures
- Identifying and assessing the risks of material misstatement
- Determining the nature, timing and extent of further audit procedures.

Determination of materiality - a matter of professional judgment

It is up to the auditor's professional judgment to determine what is material.

The auditor considers what information financial statement users need.

The auditor assumes that users of financial statements:

- know enough about business and accounting .
- understand that not every detail is included in FS
- know that some numbers in financial statements are estimates
- use the information to make business decisions

FS are prepared
up to level of
man

These explanations are only for understanding the concept and are not for exams.

The assumptions about financial statement users play a crucial role in determining the level of materiality. Here's how:

1. **User knowledge and diligence:** Assuming users have reasonable business knowledge and will study the statements carefully allows auditors to set materiality at a practical level. They don't need to focus on extremely minor details.
2. **Understanding of materiality:** Since users are assumed to know that statements are prepared and audited to materiality levels, auditors can set thresholds that balance thoroughness with efficiency.
3. **Recognition of uncertainties:** This assumption allows auditors to set materiality levels that account for inherent estimation uncertainties, rather than treating every estimate as potentially material.
4. **Economic decision-making:** By assuming users make decisions based on the statements, auditors can focus on items that could realistically impact those decisions when setting materiality.

These assumptions help auditors determine what information is significant enough to influence users' decisions. This guides where they set materiality thresholds, ensuring they focus on truly important items without getting bogged down in insignificant details.

1. Overall Materiality: Example: An auditor might set overall materiality at 5% of pre-tax income. For a company with ₹100 crore (1 billion) in pre-tax income, the materiality threshold would be ₹5 crore (50 million). Misstatements below this amount are generally considered immaterial for the financial statements as a whole.
2. Performance Materiality: Example: The auditor might set performance materiality at 75% of overall materiality. In this case, it would be ₹3.75 crore (37.5 million) (₹5 crore x 75%). This lower threshold helps ensure that the sum of smaller uncorrected misstatements doesn't exceed the overall materiality.
3. Specific Materiality: Example: For an Indian manufacturing company, cash and inventory might be particularly important. The auditor might set a specific, lower materiality for these accounts:
 1. Cash: ₹1 crore (10 million)
 2. Inventory: ₹2 crore (20 million) Even though these are below the overall materiality, errors in these accounts could significantly influence users' decisions.
4. Calculation of Performance Materiality: Example: An auditor assesses a company as medium risk. They might use 75% of overall materiality for performance materiality:
 1. Overall materiality: ₹5 crore (50 million)
 2. Risk assessment: Medium (75%)
 3. Performance materiality: ₹5 crore x 75% = ₹3.75 crore (37.5 million)

a) High-Risk Company:

- Overall materiality: ₹5 crore (50 million)
- Risk assessment: High (might use 50% or even lower)
- Performance materiality: ₹5 crore x 50% = ₹2.5 crore (25 million)

For a high-risk company, auditors would set a lower performance materiality to be more conservative. This means they would investigate smaller discrepancies, reducing the risk of missing material misstatements.

b) Low-Risk Company:

- Overall materiality: ₹5 crore (50 million)
- Risk assessment: Low (might use 80% or even higher)
- Performance materiality: ₹5 crore x 80% = ₹4 crore (40 million)

For a low-risk company, auditors might set a higher performance materiality. This allows for more efficient auditing as they can focus on larger discrepancies, reflecting the lower risk of material misstatement.

The key point is that the riskier the company, the lower the percentage used to calculate performance materiality. This results in a lower threshold for investigating discrepancies, providing greater assurance in higher-risk situation

The relationship between materiality determination and risk assessment in an audit is important to understand. Here's a guide to help you study this:

- **General Approach:**
 - In most cases, materiality is determined before conducting a detailed risk assessment.
 - However, the process is often iterative, meaning there's some back-and-forth.

- **Initial Materiality Determination**
 - Auditors typically start by setting a preliminary materiality level.
 - This is based on high-level information about the entity, such as total assets or revenues.

- **Preliminary Risk Assessment:**
 - With initial materiality in mind, auditors perform a preliminary risk assessment.
 - This involves understanding the entity and its environment.

- **Refining Materiality:**
 - Based on the preliminary risk assessment, auditors might adjust their initial materiality.
 - For instance, if unexpected high risks are identified, materiality might be lowered.

- Detailed Risk Assessment:
 - A more thorough risk assessment is then conducted using the refined materiality.
 - This helps identify specific areas of potential material misstatement.

- Final Adjustments:
 - If necessary, materiality might be adjusted again based on the detailed risk assessment.

- Ongoing Process
 - hroughout the audit, materiality and risk assessment may be revisited as new information comes to light.

Audit of TechInnovate Ltd., a mid-sized software company

1. Initial Materiality Determination:
 - Auditor reviews previous year's financials: Revenue ₹100 crore
 - Sets initial materiality at 1% of revenue: ₹1 crore
2. Preliminary Risk Assessment:
 - Auditor learns about a new major client contributing 30% of revenue
 - Identifies potential revenue recognition issues
3. Refining Materiality:
 - Due to the risk associated with the new client, auditor lowers materiality to 0.75% of revenue: ₹75 lakh
4. Detailed Risk Assessment:
 - Using ₹75 lakh materiality, auditor identifies specific risks: a) Revenue recognition for the new major client b) Valuation of in-progress software projects c) Related party transactions with a sister company
5. Final Adjustments:
 - After detailed assessment, auditor decides to keep materiality at ₹75 lakh
 - Sets performance materiality at 60% of this: ₹45 lakh
6. Ongoing Process:
 - Midway through the audit, a potential lawsuit is discovered
 - Auditor reassesses risks and considers lowering materiality further

Benchmarking

- Method for determining materiality
- %age is Applied to Chosen Benchmark as a starting point in determining Materiality for FS as a whole
- Benchmark & %age is Chosen by Auditor on the Basis of Professional Judgement

- Factors $\xrightarrow{\text{May affect}}$ identification of Apt. Benchmark
- Elements of FS (Assets, Liab, Rev/exp & Equity)
 - Attention of users of FS (Revenue / Profit / Assets)
 - Nature }
Life cycle } \rightarrow Entity
Industry
Economic Environment
 - Ownership structure / Financial Patterns
(Debt funded or otherwise)
 - Volatility

Example

Profit oriented entities — if volatile choose other

- Income — PBT, Total Revenue, GP Gross Profit
- Total Expenses
- Total Equity / Net Asset value
- Entities doing Public utility Programs

Total Cost of Project can be a good BM.

- Entities having Custody of Assets — Assets may be Apt Benchmark.

Relevant financial data for BM

- Prior period Financial Results
- Current period Financial data — upto Point of Analyst's (Most Recent Performance)
- Budget / Forecast for current period
- Adjustment for Significant changes in Benchmark
 - Circumstances (sell) Acq of Significant Business
 - Industry
 - Economic Environment

Use of Professional Judgement

- % for BM is a Matter of Professional Judgement
- % to PBT ↑ man % age Total Revenue
(Inverse Relation b/w % age & Size of BM)
- 5% PBT — Profit Oriented Entity
1% Revenue / Expenses — Non-profit Oriented
- The auditor may deem higher or lower percentages appropriate based on specific circumstances

using a lower percentage on a larger benchmark helps ensure that the materiality threshold is not set too high

Revision as the Audit Progresses

Reasons for Revision

a) change in circumstances (e.g., decision to dispose of a major part of the business)

b) New information ^{***}

c) Auditor's understanding of the entity and its operations changes

If actual financial results are likely to differ substantially from the anticipated results used to initially determine materiality, the auditor should revise the materiality threshold.

If materiality assessment lowers, the auditor must review performance materiality and audit procedures.