Chapter - 3 "Risk Assessment and Internal Control"

Topics Covered : (1) Audit Risk

(2) Materiality in planning and performing an audit : (SA 320)

Materiality

Accounting - FRF.
↓
Books of A/c + F.S.

Auditing
SA-200 - Overall objectives.
F.S - free from
✓ material
✓ misstatements

AS-1 - Disclosure of A/cing Policies
↓ selection
(a) Substance over form
(b) Prudence
(c) Materiality. SA-320.

✓ Fundamental Accounting Assumptions :
(a) Going concern
(b) Consistency
(c) Accrual.

(i) Meaning of Materiality :- As per SA 320, misstatements including omissions could be material, if individually or in aggregate with other misstatements, could reasonably be expected to influence the economic decisions of users of financial statements.

- Materiality may be determined on quantitative as well as qualitative aspects ; hence materiality is not a matter of relative size, for example, small theft of money by employees can indicate significant deficiency in Internal Control.

(ii) Concept of Materiality - based on discussion in FRF:

- As per SA 320, a discussion presented in FRF provides a reference to the auditor in determining materiality for the audit.

  For Example: Schedule III to the Companies Act, 2013, requires separate disclosure of financial items like:

  (a) Shareholding > 5% of share capital;

  (b) Income or Expenditure items that exceeds 1% of Revenue from operations or ₹ 1,00,000, whichever is higher.

- However, in the absence of any such discussion in the FRF, following principles may apply:

  (a) Any misstatement including omission are considered to be material, if they could reasonably be expected to affect the economic decision of users.

  (b) Judgements about materiality to be made based on circumstances; size and nature of misstatements, etc.

  (c) Materiality is to be considered on the basis of common information needs of users of f.s.

  (d) Materiality is a subject of professional judgement and may differ from person to person; any information which is material for a person might not be material for another person.

(iii) Auditor's consideration as to applying materiality concept:

- Concept of Materiality is required to applied by the auditor both in planning and performing the audit and in forming an opinion on the f.s.
- During planning stage, auditor is required to consider the materiality for the following:

  (a) Determining NTE of RAP;

(b) Identifying and assessing RoMM; and

(c) Determining NTE of FAP.

- While performing the audit, auditor is required to consider the materiality for the following:

(a) Determining sufficiency and appropriateness of audit evidences;

(b) Evaluation of audit Evidences;

(c) Drawing Conclusion on the basis of audit Evidences.

(iv) Auditor's assumptions about users of f.s. while determining materiality:

(a) Users have a reasonable Knowledge of business and Economic activities; and accounting.

(b) Users are willing to study the f.s. with reasonable diligence.

(c) Users understand that f.s. are prepared, presented and audited to levels of materiality.

(d) Users recognise the uncertainities inherent in measurement of Estimates.

(e) Users make reasonable Economic decisions on the basis of f.s.

(v) Performance Materiality:

Amount set by auditor, at less than materiality for the financial statements as a whole

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so as to reduce the risk to an appropriate low level, that aggregate of uncorrected and undetected misstatements may exceed materiality for f.s. as a whole.

Materiality for Income / Expense:

1% of RFO or ₹ 1 lakh : Higher

1% of 5Cr or ₹ 1 lakh = ₹ 5 lakh

While auditing Expenses, misstatements identified - (40% transaction Examined)

(a) ₹ 55,000

(b) ₹ 62,000

(c) ₹ 41,000

(d) ₹ 70,600

(e) ₹ 40,600

(f) $\boxed{₹ 31,150}$

identified uncorrected

Example:

- While planning the audit, auditor fix the materiality for the revenue items - ₹ 5,00,000
- During course of performing audit procedures, auditor observed some misstatements in the samples selected in range of ₹ 30,000 to ₹ 75,000.
- Auditor is of the view, that if ignored, aggregate of such uncorrected and undetected misstatements may exceed ₹ 5 lakhs.
- Hence auditor is required to determine performance materiality which may be fixed at any amount on professional judgement of auditor, say for example ₹ 40,000.

Remaining 60% population → undetected misstatement.

(Identified uncorrected + undetected) > ₹ 5,00,000

Performance Materiality – ₹ 40,000

10 chapters × 20 : 200 → 15

5 → lengthy

50

Obj. – x x x x x

(vi) Determining materiality and performance materiality:

Auditor is required to determine the following:

(a) Materiality for the financial statements as a whole (at the time of establishing overall audit strategy)

(b) If required, based on the circumstances, materiality for the particular class of transactions, account balances or disclosures.

(For Ex: Managerial Remuneration, Related Party disclosures, travelling expenses, trade receivable balances etc.)

(c) Performance Materiality, if circumstances so requires.

Revision as the audit progresses:

- If auditor conclude that a lower materiality for the f.s. as a whole. or particular transactions, account balances or disclosures, than that initially determined, is appropriate, auditor may revised the materiality and consider[(a)] whether there is a need to revise performance materiality and whether NTE of audit procedures remains appropriate.

- Materiality need to be revised as a result of:
  - (a) Changes in Circumstances;
  - (b) New Information obtained
  - (c) Changes in auditor's understanding of Entity and its operations as a result of performing audit procedures.

MCQ: As per SA 320, in case of revision in materiality level, auditor need to consider:

(a) Need to revise P. Materiality
(b) NTE of Audit procedures remain appropriate.
(c) Either (a) or (b)
(d) Both (a) and (b)

Documentation: Auditor documentation shall include the following:

(a) Materiality for the financial statements as a whole.
(b) " " " particular classes of transactions, account balances or disclosures.
(c) Performance Materiality.
(d) Revision of (a), (b) or (c) as audit progressed.

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(vii) Benchmark of Materiality: Materiality may be determined as a %age of
- Profit before tax;
- Total Revenue;
- Total Expenses;
- Total Equity,
- Gross Profit
- Net Assets value etc.

Most commonly used Benchmark in case of Profit making Entities are Profit Before tax. In Case of other entities, other benchmark may be applied.

Factors affecting identification of appropriate Benchmark:

(a) Elements of the financial statements.
[For Ex: Assets, Liabilities, Equity, Income and Expenses]
(b) Items on which the attention of the users of F.S. tends to be focused.
[For Ex: to evaluate financial performance, users may focus on profits]
(c) Nature of the Entity
(d) Industry and Economic Environment in which Entity operates.
(e) Entity Ownership structure and the way in which it is financed.
[For Ex.: In case of finance through debts, more emphasis will be on assets and claims over them].
(f) Relative Volatility of the benchmark.

(viii) Materiality and Audit Risk: - Self-study from book -