Implementation Guide to Materiality in Planning and Performing An Audit

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Edition	:	February, 2012
Committee/ Department	:	Auditing and Assurance Standards Board
Email	:	aasb@icai.org
Website	:	www.icai.org
Price	:	₹ 100/-
ISBN	:	978-81-8441-508-7
Published by	:	The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002.
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra 282 003 February/2012/1,000 copies

Foreword

Standards on Auditing are an important instrument in bridging the expectation gap existing between the society and the auditors regarding the expectations of the society from the auditors with regard to the audits of financial statements. It, therefore, becomes essential that the auditors properly understand and implement the Standards on Auditing in their audit engagements.

Implementation Guides to Standards on Auditing are an important tool for the auditors to appropriately understand the requirements of these Standards and help them implement the Standards in an appropriate manner to meet the objectives of these standards. The Implementation Guides also provide solutions to the practical problems in implementing these standards in the real life situations being faced by the auditors in their audit engagements.

I am happy to note that the Auditing and Assurance Standards Board is issuing a number of Implementation Guides on new / revised Standards on Auditing issued during the last 3-4 years for the benefit of the members. This Implementation Guide to Standard on Auditing (SA) 320, 'Materiality in Planning and Performing an Audit' is one such Guide. I am sure the Implementation Guide would be able to address the apprehensions, concerns and difficulties, if any, being faced by the auditors regarding this Standard on Auditing.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives in bringing out guiding literature on Standards on Auditing and other technical literature on auditing for the benefit of the members. I also eagerly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

February 8, 2012
New Delhi

CA. G. Ramaswamy
President, ICAI

Preface

Materiality is an important concept in the context of preparation and presentation of financial statements as well as the audits of financial statements. Financial reporting frameworks across the world recognize the concept of materiality in the preparation and presentation of financial statements. Materiality is a vital factor as to the nature and extent of audit coverage and procedures required in conducting an audit. In other words, the question of materiality has a direct bearing in deciding the nature, timing and extent of audit procedures as well as actual performance of audit for conducting an audit effectively.

The Institute of Chartered Accountants of India had issued a Standard on Auditing dealing with audit materiality as back as in 1997. The Standard was revised in 2007 under the Clarity Project. The Revised Standard deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

As a part of its efforts to create awareness among the members about the various Standards on Auditing issued under the Clarity Project, the Auditing and Assurance Standards Board has been bringing out Implementation Guides to these Standards on Auditing. This Implementation Guide to SA 320, 'Materiality in Planning and Performing an Audit' is one such Guide in the series. The Guide provides practical implementation guidance on various aspects relating to audit materiality in an easy and lucid language. It covers matters such as concept of materiality, determining materiality when planning the audit, revision of materiality during performance of audit, evaluating the results of audit procedures etc.

I am grateful to CA. Paratha S De, Kolkata for preparing the preliminary draft of the Implementation Guide. I am also extremely grateful to CA. Ganesh Balakrishnan, Hyderabad and his team, *viz.*, Ms. Swati Naik, Mr. Sriraman Parthasarthy and Mr. T.S. Venkateswaran for squeezing time out of their pressing professional and personal preoccupations for reviewing and giving the Implementation Guide its final shape.

At this juncture, I also wish to express my sincere thanks to CA. G. Ramaswamy, President, ICAI as well as CA. Jaydeep N. Shah, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.*, CA. Rajkumar S Adukia, Vice Chairman, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey and the Central Government nominees, Shri Prithvi Haldea and Smt. Usha Sankar and also to the co-opted members at the Board, *viz*., CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan, CA. Ramana Kumar B., for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz*., CA. Vinod Chandiok, Prof. A. Kanagaraj, CA. Amit Roy, Shri Sunil Kadam, CA. Raj Agrawal, CA. Bhavani Balasubramanian, CA. K. Rajasekhar, CA. Harinderjit Singh, CA. N. Venkatram, CA. B. Padmaja, CA. L. Kamesh for their support to the Board. I also wish to place on record my thanks to CA. Puja Wadhera, Secretary, Auditing and Assurance Standards Board and her team, *viz.,* CA. Rajnish Aggarwal, Education Officer and Mrs. P. Anitha, Steno-typist for their efforts in giving the Implementation Guide its final form.

I am sure that the members and other interested readers would find this Implementation Guide useful. I also eagerly look forward to the feedback of readers on the publication.

February 2, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

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Revised SA 320

Materiality in Planning and Performing an Audit

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

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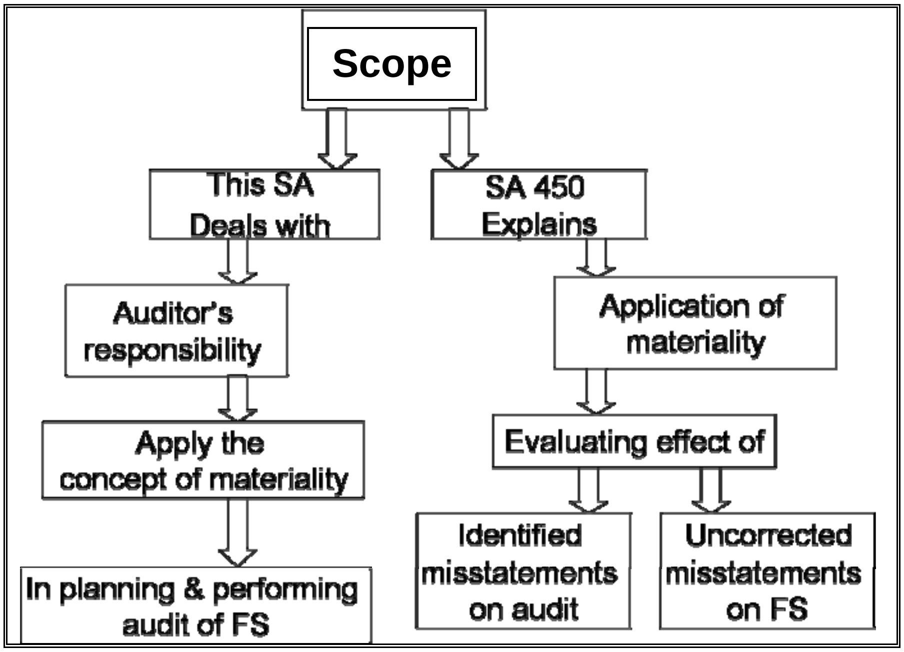


* FS – Financial Statements

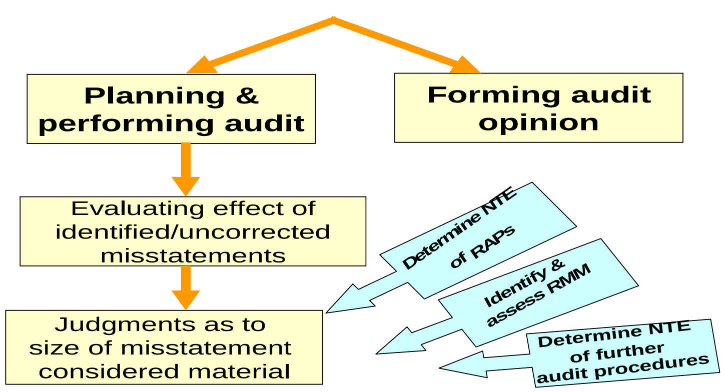
Materiality in the Context of an Audit

- FRFs normally discuss "materiality" in context of preparation & presentation of FS:
  - Misstatements are material if in aggregate/ individually may influence economic decision of users.
  - Judgments on materiality made in the light of surrounding circumstances.
    - Affected by size/nature of misstatements or both.
  - Judgments on matters material for FS users are based on common financial info needs as a group:
    - Not specific needs.

* FRF – Financial Reporting Framework

- Determination of materiality is matter of professional judgment:
  - Affected by auditor's perception of info needs of FS users.
- Auditor may assume that users:
  - Have:
    - Reasonable knowledge of business & economic activities & accounting.
    - Willingness to study FS with reasonable diligence.
  - Understand that FS are prepared, presented & audited to levels of materiality.
  - Recognise inherent limitations in accounting estimates, judgments & consideration of future events.
  - Make reasonable economic decisions based on info in FS.

Consideration of Materiality



Materiality and Audit Risk:

- Materiality and audit risk are considered throughout audit, in particular, when;
  - Identifying and assessing the risks of material misstatement;
  - Determining the nature, timing and extent of further audit procedures; and
  - Evaluating the effect of uncorrected misstatements, if any, on the FS and in forming the opinion in the auditor's report.

\# NTE = Nature, Timing and Extent
RAPs = Risk Assessment Procedures

Auditor's Objective

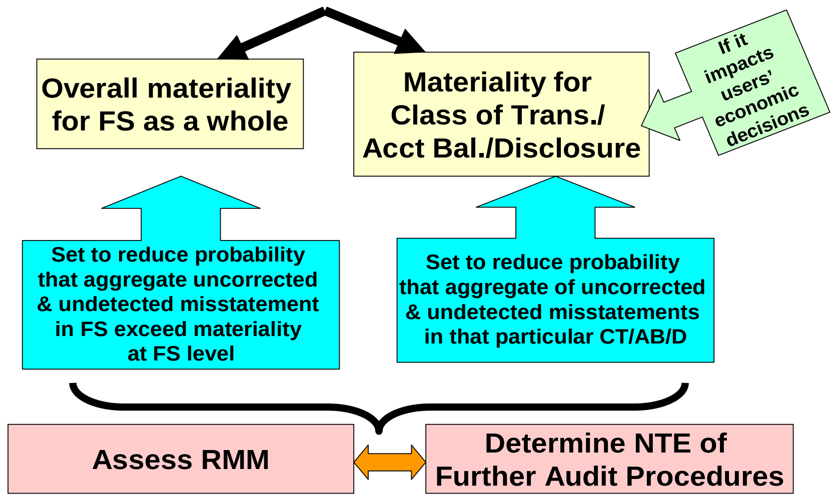
- Apply the concept of materiality.
- Appropriately in planning and performing the audit.

Definition

- **Performance materiality:**
  - Amount(s) set by auditor at less than materiality for FS as a whole.
  - To reduce to an appropriate low level.
  - Probability that aggregate of uncorrected & undetected misstatements exceeds materiality for FS 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.

Determining Materiality & Performance Materiality in Planning



- Materiality determination is done while establishing the overall audit strategy.
- Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the FS to be materially misstated, and leaves no margin for possible undetected misstatements.
- Determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by:
  - Auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
  - Nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

\# RMM = Risk of Material Misstatements

Using Benchmarks to Determine Materiality at FS level

- Involves use of professional judgment.
- Starting point - a percentage often applied to a chosen benchmark.
- For less/ more than 12 month FS period, materiality relates to whole of that period.
- Chosen benchmarks ordinarily include:
  - Prior period financial results & State of Affairs (SoA).
  - Period to date results & SoA.
  - Budgets & forecasts (adjusted for significant changes).
  - Changes in the industry/economic environment of entity.

- Factors affecting identification of an appropriate benchmark include:
  - Elements of FS.
  - Items of focus for users of FS.
  - Nature of the entity.
  - Industry & economic environment.
  - Ownership & finance structure.
  - Relative volatility of benchmark.
- Chosen Benchmark:
  - For example, when, as a starting point, the materiality at FS level is determined for a particular entity based on a percentage of Profit before Tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality at FS level is more appropriately determined using a normalised Profit before Tax from continuing operations figure based on past results.

Materiality for Classes of Transactions/ Account Balances/ Disclosures

- Factors that may indicate need to set such materiality level:
  - L&R or FRF affect users' expectations regarding measurement/ disclosure of certain items.
  - Key disclosures wrt industry in which entity operates.
  - Focus on particular aspects of entity's business that is separately disclosed in FS.

- In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, auditor may find it useful to obtain an understanding of views and expectations of TCWG and management.

\# L&R = Laws and Regulations

Revision as Audit Progresses

- Revise materiality if auditor becomes aware of information during audit :
  - That would have caused him to have determined a different amount initially.
- If materiality level requires lowering, determine:
  - Need to revise performance materiality.
  - Appropriateness of Nature, Timing and Extent (NTE) of further audit procedures.

- Materiality may need to be revised as a result of:
  - A change in circumstances that occurred during the audit for example, a decision to dispose of a major part of the entity's business.
  - New information.
  - A change in auditor's understanding of entity and its operations as a result of performing further audit procedures.
  - For example, if during audit it appears as though actual financial results are likely to be substantially different from anticipated period end financial results that were used initially to determine materiality for FS as a whole, auditor revises that materiality.

Documentation

- Include following amounts & the factors considered in their determination:
  - Materiality for FS as a whole.
  - Materiality level for
    - Class of Transactions
    - Account Balance
    - Disclosures
  - Performance materiality.
  - Any revision to any of above.

SA 450

Evaluation of Misstatements Identified During the Audit

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

Overview of SA 450

- **Introduction**
  - Scope
  - Effective Date
- **Objective**
- **Definitions**
- **Requirements**
  - Accumulation of Identified Misstatements
  - Consideration of Identified Misstatements as the Audit Progresses
  - Communication & Correction of Misstatements
  - Evaluating the Effect of Uncorrected Misstatements
  - Written Representation
  - Documentation
- **Application and Other Explanatory Material on these aspects.**

Scope

- **Auditor's responsibility to evaluate effect of:**
  - Identified misstatements on audit; and
  - Uncorrected misstatement (if any) on FS.
- Auditor's opinion as per Revised SA 700 influenced by evaluation of impact of uncorrected misstatements on FS as per SA 320.

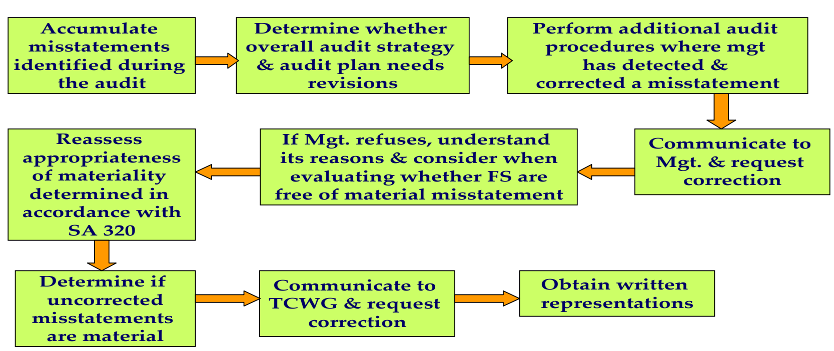
Auditor's Objective

- Evaluate:
  - Effect of identified misstatements on audit; and
  - Effect of uncorrected misstatements (if any) on FS.

Definitions

- **Misstatement:**
  - Difference between:
    - Amount/classification/presentation/disclosures of reported FS item *vis-à-vis*
    - Requirements of FRF.
  - Includes adjustments as are necessary, in auditor's judgment, to provide True & Fair view.
  - Can arise from fraud/ error.
- **Uncorrected Misstatements:**
  - Misstatements accumulated by auditor during the audit; and
  - That have not been corrected.
- **Misstatements may result from:**
  - An inaccuracy in gathering or processing data from which FS are prepared.
  - An omission of an amount or disclosure.
  - An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts.
  - Judgments of management concerning accounting estimates that auditor considers unreasonable or selection and application of accounting policies that auditor considers inappropriate.
  - Examples of misstatements arising from fraud are provided in Revised SA 240.

Basic Flow of the Audit Process



Accumulation of Identified Misstatements

- Accumulate misstatements identified during the audit:
  - Except those clearly trivial.
- Types of misstatements:
  - Factual.
  - Judgmental.
  - Projected.

- Concept of Clearly Trivial:
  - Clearly trivial does not mean not material. These are matters that are:
    - Wholly smaller than that determined in accordance with Revised SA 320; and
    - Are clearly inconsequential, individually or in aggregate and by any criteria.
  - If there is an uncertainty whether one or more items are clearly trivial, the matter is not considered clearly trivial.
- To assist auditor in evaluating the effect of misstatements accumulated during audit and in communicating misstatements to management and TCWG, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
  - **Factual misstatements -** Misstatements about which there is no doubt.
  - **Judgmental misstatements** - Differences arising from:
    - judgments of management concerning accounting estimates that auditor considers unreasonable, or
    - selection or application of accounting policies that auditor considers inappropriate.
  - **Projected misstatements -** Auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Consideration of Identified Misstatements as the Audit Progresses

- Determine need to revise overall audit strategy & audit plan if:
  - Nature of identified misstatements & circumstances of occurrence indicate existence of other (possibly material) misstatements; or
  - Aggregate of misstatements accumulated during audit approaches materiality determined as per SA 320 (Revised).
- Perform additional procedures, if at auditor's request:
  - Management has examined a CoT/AB/D and
  - Corrected misstatements that were detected to determine if misstatement remain.

- A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised), there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.
- Auditor may request management to examine a class of transactions, account balance or disclosure to understand the cause of a misstatement identified by auditor, perform procedures to determine the amount of actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to FS. Such a request may be made, for example, based on auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication & Correction of Misstatements

- Communicate:
  - On timely basis.
  - All misstatements accumulated during the audit.
  - To appropriate level of Mgt.

  Unless prohibited by law/ regulation.

- Request Management to correct misstatements.
- If Management refuses correction:
  - Understand its reasons; and
  - Take that into account when evaluating whether FS as a whole are free from material misstatements.

- **Timely communication** is important because it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. **Appropriate Level of Management** is one that has responsibility and authority to evaluate misstatements and to take the necessary action.
- **Prohibition by L & R:**
  - L&R may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act.
  - In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.
- Correction of all misstatements, including those communicated by auditor, enables management to:
  - Maintain accurate accounting books and records; and
  - Reduces risks of material misstatement of future FS because of cumulative effect of immaterial uncorrected misstatements related to prior periods.

Evaluating the Effect of Uncorrected Misstatements

- Reassess appropriateness of materiality determined as per SA 320(R) in context of entity's actual financial results.
- Determine if uncorrected misstatements are material, individually or in aggregate. Factors to consider:
  - Size & nature of misstatements.
  - Particular circumstances of occurrence of misstatement.
  - Effect of uncorrected misstatements related to prior periods.

- This assessment is to be done prior to evaluating effect of uncorrected misstatements. The auditor's determination of materiality in accordance with SA 320 (Revised) is often based on estimates of entity's financial results, because actual financial results may not yet be known. Therefore, prior to auditor's evaluation of effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 (Revised) based on the actual financial results.

- Consider each misstatement to evaluate its effect.
- A material misstatement is unlikely to be offset by other misstatements.
- May offset immaterial misstatements within the same AB/CoT:
  - But consider risk of existence of further undetected misstatements.
- Determining whether a classification misstatement is material involves evaluation of qualitative considerations.
- The circumstances related to some misstatements may cause the auditor to evaluate them as material, even if they are lower than the materiality for the financial statements as a whole.

- Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the FS as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses.
- Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as:
  - Effect of the classification misstatement on debt or other contractual covenants, and
  - Effect on individual line items or sub-totals on the effect on key ratios.
- SA 240 (Revised) explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of misstatement is not material in relation to the FS.

- Evaluation whether a misstatement is material also affected by L&R and additional responsibilities for the auditor to report other matters, including, for example, fraud.
- Issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature.
- The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements.

Communication with TCWG

- Communicate:
  - Uncorrected misstatements (Identify material uncorrected misstatements individually), and
  - Impact (individually/aggregated) on audit opinion,

Unless prohibited by Laws and Regulations

- Request correction of uncorrected misstatements.
- Also communicate effect of Uncorrected misstatements of prior periods.

- Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate:
  - Number and overall monetary effect of uncorrected misstatements rather than details of each individual uncorrected misstatement.
  - The auditor may discuss with TCWG the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representations

- From Management or TCWG (where appropriate):
  - Whether they believe effects of uncorrected misstatements are immaterial, individually/in aggregate, to FS as a whole:
    - Summary of such items to be included/ attached to Written Representations

- Where, Mgt./ TCWG do not believe that certain uncorrected misstatements are misstatements, they may want to add to their written representation words such as: "We do not agree that items……and….. constitute misstatements because [description of reasons]". Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

TCWG = Those Charged With Governance

Documentation

- Include:
  - Amount below which misstatements would be regarded as clearly trivial.
  - All misstatements accumulated during the audit and whether they have been corrected.
  - Auditor's conclusion as to:
    - Whether uncorrected misstatements are material, individually or in aggregate, and
    - Basis for that conclusion.

- Auditor's documentation of uncorrected misstatements may take into account:
  - The consideration of the aggregate effect of uncorrected misstatements.
  - The evaluation of whether the materiality level or levels for a particular classes of transactions account balances or disclosures, if any, has been exceeded.
  - The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).

Chapter 1

Concept of Materiality

1.1 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, if any, on the financial statements and in forming the opinion in the auditor's report.

1.2 Financial reporting frameworks across the globe mention the concept of materiality in the context of the preparation and presentation of financial statements. The term materiality has been referred in various pronouncements on the preparation of the financial statement and reporting thereof.

- **Paragraph 30 of the "Preface to the Accounting Standards"** issued by ICAI dealing with "Qualitative Characteristic of Financial Statements", states as under: -

  "The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful."

- **'Guidance Note on terms used in Financial Statements'** issued by ICAI defines materiality as *"an accounting concept according to which all relatively important and relevant items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements".*

- **AS 1 "Disclosure of Accounting Policies"** requires materiality as one of the consideration in the selection of accounting policies as under: -

  "Financial statements should disclose all 'material' items i.e. items the knowledge of which might influence the decisions of the users of the financial statements".

- **'Guidance Note on Accrual Basis of Accounting'** issued by ICAI provides under headline: para 6 *concept of materiality* as mentioned below: -

  Concept of Materiality in the Context of an Audit

  The aspects of materiality is a vital factor as to the nature and extent of audit coverage required in conducting an audit i.e. the question of materiality has a direct bearing in shaping an audit programme aiming to conduct an audit effectively.

- **IAS 1 "Presentation of Financial Statements"** requires each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only which are individually immaterial.

- **IAS 34 "Interim Financial reporting"** requires materiality should be assessed in relation to the interim period financial data. Interim measurements may rely on estimate to a greater extent than measurements of annual financial data.

- **Materiality Concept as per RBI guidelines based on N.D. Gupta Committee**

  "In his approach to audit, the auditor should keep in mind the concept of 'materiality'. Items that do not materially affect the views presented by the financial statements may be ignored. While suggesting any changes due to wrong classification or mistakes in grouping or wrong head of account, through the Memorandum of Changes, the branch auditor has to be guided by the materiality concept. In case of some banks, Head Office circular indicates the

quantum of materiality to be considered by the branch auditor. The concept of materiality is fundamental to the reporting of information. Materiality depends on the size, nature and circumstances. Hence, the branch auditor has to decide on the materiality taking into account the amount involved and the impact of the financial statement. If there is a basic mistake in the accounting principle, then such transactions may be reported through Memorandum of Changes even if the amount involved is not material."

- **Kohler's Dictionary for Accountants defines materiality as follows**

  "The relative importance, when measured against a standard of comparison of any item included in or omitted from books of account or financial statements or of any procedure or change of procedure that conceivably might affect such statement. Certain items become material through law, administrative regulation and directors' resolution or other fiat. Other items are regarded a material because of convention, custom or current social emphasis and after the only means of determining relative. Importance are based on such factors as the relative size and general characteristic of item and assumed responsibilities of the management to shareholders, employees and the public. Moreover, the factors of importance today may be of greater or less importance tomorrow. Financial statements as representations of corporate management can be prepared have been well developed. Unimportant items are merged with other items of the same general class or may perhaps be omitted altogether (e.g. minor accruals or pre-payments), important items may require varying degrees of disclosure, a separate listing, a footnote, or parenthetical mention. Some accountants have endeavored to establish standard of materiality by rules of thumb as by requiring that any item or item class, the money amount of which is 5% or more of total assets or 10% or more of net income as an integral of financial statement. Such a rule however, leaves

unsolved the problem of smaller amounts whose disclosure may be essential regardless of their size and where certain items now of minor importance may develop into major items with the passage of time or upon the happening of events now contingent or even unknown ………."

Concept of Materiality needs to be applied in the preparation of financial statements and reporting thereof. Financial Statements are prepared and presented for the users or stakeholders. They take the economic decision on the basis of financial statements. Thus, the financial statements should disclose all material items i.e. the items knowledge of which might influence the decisions of the users.

Considerations in Preparing and Presenting Financial Statements

Users of Financial Statements

1.3 The basic consideration in the preparation and presentation of general purpose financial statements is the common financial information need of the users or stakeholders and not of any specific individual users.

Generally accepted accounting principles on the basis of which the financial statements are prepared

1.4 This includes: -

- Accounting principles commonly accepted and used and those pronounced in the Framework and Accounting Standards issued by the relevant standard setting body.
- selection of accounting policies for the disclosure of all material items (the knowledge of which might influence the decisions of the users of the financial statements).
- Disclosure of accounting policies, viz.:

- All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed and should form part of the financial statements.
- Any change in the accounting policies which has a material effect should be disclosed along with the amount by which any item in the financial statements is affected by such a change. If such amount is not ascertainable fully or any part thereof, the fact should be disclosed with reason therefor.
- Principles of consistency and conservatism are also to be complied with while preparing and presenting the financial statements. Under principle of consistency, the same accounting policies and principles need to be followed from one period to the next. Under the principle of conservatism, while preparing the financial statements, management should recognise all possible expenses/ losses but should not account for any probable income/ gains.

Accrual Basis of Accounting

1.5 As explained in the Accounting Standard on Disclosure of Accounting Policies (AS-I) issued by the ICAI, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate, i.e., the concept of accounting on accrual basis.

1.6 The accrual basis of accounting or mercantile basis of accounting is method of recording transaction by which revenue, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. This includes considerations relating to: -

- deferrals,
- allocations,

- depreciation and
- amortization

1.7 The recording of a transaction is made on the following basis: -

- on accrual and not at the line of occurrence of actual flow of money.
- income is accounted for when earned.
- expenses or payments are accounted for when due and payable.
- All known losses are accounted for in the accounting period in which these are determinable.

1.8 This, however, does not necessarily imply that detailed calculations are required to be made in respect of even smallest and immaterial amounts of revenue and expenditure. Thus it may not be improper to write off items of lower value even through it is expected to be used for more than one year. However ascertaining whether an amount is lower or higher is a relative consideration and is based on the size of the entity.

1.9 An individual item should be judged to be material if the knowledge of that item could reasonably be deemed to have influence on the users of financial statements. 'Statement on Auditing Practices' issued by the Institute of Chartered Accountants of India states that the recommendation contained in the statements apply primarily to items which are material and significant in relation to the affairs of the company.

Concept of True and Fair View

1.10 The concept of 'true and fair' view also recognises that the concept of materiality must be given due importance in the preparation and presentation of financial statements.

1.11 Section 209(3) of the Companies Act, 1956, requires that every company has to keep the books of account in such a manner that they give a 'true and fair view' of its state of affairs and that the books are maintained on the accrual basis of accounting.

1.12 Materiality, thus, is a crucial factor for the statutory auditor in forming or expressing an opinion mainly based on judgment in respect of certifying the financial statements as to their 'true and fair' presentation or whether the financial statements are 'presented fairly'.

Factors for Determining Materiality

1.13 An amount is not material solely by reason of its size. Other factors including those set out below need to be considered in making decisions as to materiality.

1.14 The nature of the item, i.e., whether it is: -

a) a factor entering into the determination of net income.

b) unusual or extraordinary.

c) contingent upon an event or condition.

d) determinable based upon existing facts and circumstances.

e) required by statute or regulation, the amount itself, in relation to:

  i) the financial statement taken as a whole.

  ii) the total of the accounts of which it forms, or should form a part.

  iii) related items.

  iv) the corresponding amount in previous years.

  v) expected amount in future years.

1.15 The question of materiality is, therefore, particularly relevant in respect of: -

- Profit (or Loss) before taxation
- Turnover

- Net Tangible Assets
- Net Current Assets
- Current Liabilities
- Income or expenditure of an exceptional or non-recurring nature
- Trends in turnover and profits before taxation

1.16 In a trend analysis for assessing materiality, transactions which are exceptional, unusual or non-recurring in nature are to be excluded as those items tend to distort the actual state of affairs of the business in terms of turnover, profits and returns on capital employed.

Performance Materiality

1.17 A new term "Performance Materiality" has been introduced in Standard on Audit (SA) 320, Materiality in Planning and Performing an Audit". Paragraph 11 of SA 320 requires that for the purpose of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures auditor shall determine "Performance Materiality". The term "Performance Materiality" has been defined in paragraph 9 of SA 320 as follows:

"For purposes of the SAs, 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."

1.18 Further, paragraph A12 of SA 320 explains that:

"Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may: -

- *cause the financial statements to be materially misstated; and*
- *leaves no margin for possible undetected misstatements.*

Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period."

1.19 The underlying concept of performance materiality, which is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole, is not new as in para 5 of the erstwhile SA 320 (i.e., AAS 13, "Audit Materiality") it was already stated that,

"The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transaction……………………………………………………"

1. 20 But the term "Performance Materiality" is new and is considered as the primary benchmark for the auditor to assess the nature, timing and extent of risk assessment procedures and plan and perform associated audit procedures to mitigate those risks.

1.21 For example auditor's verification of individual accounts of customers may reveal error in discount allowed/credited that may be immaterial at the level of an individual customer but if aggregated as a whole for the company this may exceed the level of materiality. The auditor, therefore, while planning the audit should consider the effect of such aggregated impact based on his understanding of the entity updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

1.22 Examples of application of performance materiality:

- Variation between 5 to 10 % of current year and previous year income and expenditure
- Cost of repairs and maintenance in relation to the fixed assets
- Closing stock valuation *vis-à-vis* production, consumption and sales.
- Cost of assets as additions during the year in relation to loans/internal funds applied for financing such assets.

1.23 Materiality may have to be judged on a single item in relation to the group of assets and liabilities, e.g., for a single item of assets in the context of total assets and for a single item of liability in the context of total liability.

1.24 Normally, the same monetary precision has to be applied both in respect of profit and loss account items and balance sheet items because the materiality has to be judged for an item in profit and loss account which has a corollary effect on the balance sheet also. For example, when examining the overstatement of sundry debtors, the auditor will have to relate this to the over statements of sales also. Similarly, the reasonableness as to the provision for bad debts and for doubtful debts must be linked with sundry debtors as well as to sales. Similarly, when profit before tax is low in comparison to the turnover, the focus will be on turnover as well as on the co-relationship of different nature of expenditures, particularly, 'cost of sales' (or Cost of Goods Sold).

1.25 In assessing materiality in connection with the above significant aspects of financial statements, the question of monetary precision also has to be set out. Since ultimately, misstatements and materiality in financial statements boils down to monetary impact.

1.26 In the context of materiality in financial statements for audit of accounts, the monetary precision may based on the maximum amount of misstatement that could probably occur which may not make the financial statements misleading. Professional judgment is a crucial factor for deciding on materiality in financial statements.

1.27 In respect of materiality, the auditor's judgment is based on monetary precision, i.e., deciding on what the amount which is likely to be material to the financial statements – maximum amount by which the financial statement would be misleading.

1.28 The form and content is based on the concept of materiality in the context of preparation and presentation of financial statement. Schedule VI to the Companies Act, 1956 has been framed taking into account the concept of materiality. The revised Schedule VI also takes into account the materiality concept, for the purposes of presentation and disclosures of financial statement information.

Misstatement

1.29 A "misstatement" is the difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

1.30 When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

Uncorrected Misstatements

1.31 "Uncorrected misstatements" refers to misstatements that the auditor has accumulated during the audit and that have not been corrected.

Determine the Threshold for Clearly Trivial Misstatements

1.32 Auditor may designate an amount below which Misstatements would be clearly trivial and would not need to be accumulated because he expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial are of a wholly different (smaller) order of magnitude than materiality, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

1.33 Up to 5 percent of materiality is often considered as clearly trivial. The auditor may determine, based on the facts and circumstance of the entity and the audit engagement, that a lower level is appropriate. Factors such as the nature of the entity, history of misstatements, and number of locations may affect the actual threshold of what the auditor may consider as clearly trivial. If it is anticipated that the accumulated Uncorrected Misstatements might approach the amount deducted from materiality when determining Performance Materiality, the auditor may decide to apply a lower percentage to determine the actual threshold of what would be considered clearly trivial.

Illustrative Factors for Consideration of Materiality

1.34 Whether or not the knowledge of an item would influence the decisions of users of financial statements would depend on a particular facts and circumstances of each case. It is not possible to lay down precisely, either in terms of specific items or in terms of amounts, what could be considered as material in all circumstances.

Factors for consideration	Illustration
Materiality to users is based on common financial need of users of group and thus possible effect of misstatement on specified individual user whose need may vary widely need not be considered.	Paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by ICAI in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".
Apart from the size (or magnitude) of an item, its nature is also an important factor in determining whether or not it is material in the facts and circumstances of a case.	If the discovery of an illegal payment, even of a small amount could result in the closure of an enterprise, the item is material. Similarly, inadequate or improper description of an accounting policy would be material if it is likely to mislead the users of the

	financial statements.
Materiality can be judged only in a relative context.	In a small business, Rs.1000 may be material amount, whereas in a giant undertaking, even Rs.10,000 may not be considered material.
An item of information is material, if its omission or misstatement can influence the economic decisions of the users of the information.	If fake sales of significant amounts are recorded in the books of account of a company, it would result in over-statement of sales and profit as shown by the financial statements. A potential investor may be induced by the figure of profit shown in the financial statements to invest in the shares of the company.
What is material depends upon the particular facts and circumstances of each case.	For example, omission of sale invoice of Rs.10000/- in an enterprise with turnover of say Rs.1000 crores, may not normally be material. However the omission could become material if the turnover of the enterprise were say Rs.5 lacs.

Determining Performance Materiality

Example 1

1.35 Materiality for entity AA has been set at Rs. 5,000,000 for the current period audit and the engagement team is about to determine performance materiality next. Entity AA is an IT consulting firm and there have been no significant changes in the entity's business, internal control, risks of material misstatement or management. The entity has been an audit client for the last five years and the uncorrected misstatements have been in the region of 20% - 30% of materiality during the client relationship. Last audit's uncorrected misstatement amounted to Rs. 1,034,280 (none of which carry over to this period).

The engagement team determined performance materiality to be Rs. 3,500,000.

Example 2

1.36 For the following audit of entity AA, materiality has been set to Rs. 5,000,000 again. The uncorrected misstatements in the previous audit were Rs. 1,243,257. There have been no significant changes in the entity's business, internal control or risks of material misstatement but the entity has partly new management starting a few months into the current period. In planning meetings with management they declared that they intend to correct all identified misstatements, unless clearly trivial.

Considering the above circumstances, the engagement team determined performance materiality to be Rs. 4,500,000.

Example 3

1.37 Materiality for entity BB has been set at Rs. 900,000 for the current period audit. Entity BB is an importer of fine Italian wine and food and has been an audit client for two years. There have been no significant changes in the entity's business, internal control, risks of material misstatement or management. Last audit's uncorrected misstatement amounted to Rs. 421,853 with two of the misstatements carrying over and reversing in the current period to an amount of Rs. 171,853. The engagement team's best estimate of this period's uncorrected misstatements is to be similar to the prior period.

Considering the last period's uncorrected misstatements and the carry over effects of these misstatements, the engagement team determined performance materiality to be Rs. 650,000.

Chapter 2

Determining Materiality When Planning the Audit

2.1 As per paragraph 10 and 11 of SA 320 (Revised), one of the requirements is to determine materiality and performance materiality when planning the audit.

2.2 Further, paragraph 11 of SA 200 (Revised),"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states as follows:

"In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings."

2.3 SA 200 (Revised), paragraph 17 states as follows:

"To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

2.4 SA 200 (Revised), paragraph 13(c) defines the Audit Risk as follows:

"The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk".

2.5 As per Revised SA 320, the objective of the auditor is to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Impact of Materiality in Planning an Audit

2.6 SA 315 states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

2.7 Once the risk of material misstatements at both the financial statement level and assertions level are identified and assessed, the auditor is responsible to design and implement the related responses in accordance with SA 330, "The Auditor's Responses to Assessed Risks"*.* This includes determination of the nature, extent and timing of further audit procedures in response to these risks.

2.8 While establishing the overall audit strategy in keeping with the requirements of SA 300 (Revised) 'Planning an Audit of Financial Statements', the auditor needs to consider the materiality for the financial statements as well as carry out preliminary identification of significant components and material classes of transactions, account balances and disclosure which he plans to examine.

2.9 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.

2.10 The auditor takes into account the materiality, while determining the sample size, for testing the account balances. Materiality forms the basis for determination of audit scope and the levels of testing the transactions.

Determination of Materiality

2.11 Whether or not the knowledge of an item would influence the decisions of users of financial statements would depend on a particular facts and circumstances of each case. It is not possible to lay down precisely, either in terms of specific items or in terms of amounts, what could be considered as material in all circumstances. The auditor has to use his judgment to determine whether a particular item is material or not in a given situation. However, the following general considerations may be useful to an auditor in forming this judgment.

2.12 Materiality can be judged only in a relative context. In a small business, Rs.1000 may be material amount, whereas in a giant undertaking, even Rs.10000 may not be considered material.

2.13 In many cases, percentage comparisons may be useful in determining the materiality of an item. For example, Revised Schedule VI to the Companies Act, 1956 requires that the following items are required to be disclosed separately in the Profit and Loss Account besides others: -

- Other expense exceeding 1 percent of the revenue from operations of the company or Rs.100,000 whichever is higher.
- As additional information:
  - Total value of all imported raw materials, spare parts and components consumed during the financial year.
  - Total value of all indigenous raw materials, spare parts and components consumed during the financial year.
  - The percentage of each to the total consumption.

2.14 Thus, the law recognises that even items which are of small value individually should be considered as material if they are so numerous as to constitute more than a cutoff point. Percentages as indicators of materiality, other than those specified by law, should be used with care and only as a rule of thumb because many other factors also affect the materiality of an item, apart from its relative amount or quantity.

2.15 The relative significance of an item has to be viewed from many angles while judging its materiality. For example, an item in the Profit and Loss Account would be considered material from the perspective of its impact on the overall figure of profit and loss. Thus, if the item affect the profit or loss figure significant, it will be a material item. Another indicator would be its impact on the total of the category of the expenditure or income to which it pertains. Thus, a particular amount received as dividend will be material if it considerably affects the total amount of income from investment. Another angle to judge the materiality of the item can be to compare it with the corresponding figure in the previous year. Suppose the item is of a low amount in the current year, whereas in the previous year, it was of a much higher amount, it becomes material. Materiality of an item can be judged (a) by considering the impact that it has on the profit and loss, or on the balance sheet, or in the total of the category of items to which it pertains, and (b) on its comparison with the corresponding figure for the previous year.

2.16 In many circumstances, even small amounts may be considered material. Thus, if there is a statutory requirement of disclosure of amounts paid as sitting fee to directors, the amounts so paid should be disclosed precisely and separately. Similarly, a payment of Rs.10000 to directors as remuneration in excess of the statutory limits may be material. A small inaccuracy may be considered material if it converts a loss into a profit or *vice versa*. Similarly, if it creates or eliminates a margin of solvency in the balance sheet, it will be a material item.

2.17 In offsetting and aggregating items, care should be taken to ensure that material items of different nature are not setoff against or aggregated with each other.

Benchmark in Determining Materiality for the Financial Statements and Using Thereof

2.18 Basically, materiality determination involves the exercise of professional judgment. But a percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

2.19 Factors affecting identification of an appropriate benchmark includes the following:

Factors	Consideration/Attributes/Example
Elements of the financial statements	Assets, Liabilities, Equity, Revenue, Expenses
Need to focus item of attention of the users of a particular entities' financial statements	For example, for the purpose of evaluating financial performances users may tend to focus on profit revenue or net assets
The nature of entity	Where the entity is at in its life cycle, and the industry and economic environment in which the entity operates.
The entity's ownership structure and its funding pattern	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
Relative Volatility of the Benchmark	
Appropriateness of the example of benchmark	Circumstances of the entity which includes categories of reported income: ➢ Profit before tax (PBT) ➢ Total revenue ➢ Gross profit ➢ Total expenses ➢ Total equity/net asset value (NAV)

For profit oriented entities	Profit before tax from continuing operation is used
In case of entities where PBT is volatile	Other benchmarks may be more appropriate such as gross profit or total revenues
In relation to the chosen benchmark	Relevant financial data ordinarily includes: ➢ Prior period financial results and financial position ➢ The period to-date financial results and financial position ➢ Budgets or forecasts for the current period ➢ Adjusted for significant changes in the circumstances of the entity (Example a significant business acquisition) ➢ Relevant changes of conditions in the industry or economic environment in which the entity operates (For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations figure based on past results.)

2.20 Materiality relates to the financial statements prepared for that financial reporting period on which the auditor is reporting. What benchmarks and to which extent these will be applied are assessed with professional judgment. There is a relationship between the percentage and the chosen benchmark. A percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

Example

2.21 The auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Consideration Specific to Small Entities

Features	Benchmark
➢ Owner managed business ➢ PBT from continuing operation is consistently nominal ➢ Owner takes much of the PBT in the form of remuneration	PBT may be more relevant

Consideration Specific to Governments (Central & State) and Related Government Entities (Agencies, Board, Commission)

Features	**Benchmark or the determination of materiality for the financial statement as a whole if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the**

	financial statements of those entities may therefore be influenced by
➢ Legislators and regulators are often primary user of the financial statements ➢ Financial statements may be used to make decision other than the economic decision	➢ Legislative and Regulatory requirement ➢ Financial information need of the Legislator Public in relation to public utility programs/projects (like Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities).

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures

Factors indicating the existence of	**Consideration Of The Auditor**
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 reasonably and expectedly to influence the economic decisions of users taken on the basis of the financial statements	
➢ Whether law, regulations or the applicable financial reporting framework affect	To obtain an understanding of the views and expectations of those

users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance). ➢ The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company). ➢ Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).	charged with governance and management.

Revision As the Audit Progresses

2.22 The auditor needs to revise materiality in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures).

2.23 The need of revisit may arise as a result of a change in circumstances as stated above and that occurred during the audit.

Example

- A decision to dispose of a major part of the entity's business, new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

- If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

2.24 If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Examples of Determining Materiality

Example 1

2.25 The engagement team of entity A is in the process of determining materiality for the current period's audit. The entity is a listed entity in the publishing business. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.26 Engagement risk has been determined as normal. Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 7.5% to be applied to the chosen benchmark.

2.27 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 335,060,000. Applying the chosen percentage, 7.5%, to the benchmark amount, Rs. 335,060,000, gives Rs. 25,129,500.

2.28 The engagement team consequently determines materiality for entity A to be Rs. 25,000,000.

Example 2

2.29 The engagement team of entity B is about to determine materiality for the entity which is a listed entity that develops and sells computer games. The entity's management has informed the engagement team that there are strong indications that the entity will be acquired within the next 12 month by one of the country's largest media groups. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.30 There have been no significant changes in the entity's business, management or internal control. Using professional judgment, based on knowledge of the users of the entity's financial statements and considering the fact that the entity is likely to be acquired during or shortly following the period under audit, the engagement partner has chosen 5% to be applied to the chosen benchmark.

2.31 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 147,350,000. Applying the chosen percentage, 5%, to the benchmark amount, Rs. 147,350,000, gives Rs. 7,367,500.

2.32 The engagement team consequently determines materiality for entity B to be Rs. 7,500,000.

Example 3

2.33 Entity C is a listed entity that manufactures and sells office supplies. The entity has been an audit client for a number of years and the engagement risk has been determined as normal. The entity has had a slow but steady growth in revenue and dividends. It has inconsequential 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 very effective. There have been no significant changes in the entity's business, management or internal control during the period. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.34 Due to the entity's low external debt and knowledge of the entity as having effective internal control and accurate financial reporting, the engagement partner has chosen 10% to be applied to the chosen benchmark.

2.35 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 833,250,000. Applying the chosen percentage, 10%, to the benchmark amount, Rs. 833,250,000, gives Rs. 83,325,000.

2.36 The engagement team consequently determines materiality for entity C to be Rs. 83,000,000.

Example 4

2.37 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. It is a well-known fact that the key performance indicator for entities in this industry is net assets and the engagement partner has therefore determined that this is the most appropriate benchmark to use in determining materiality.

2.38 Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 2% to be applied to the chosen benchmark.

2.39 The engagement team has estimated net assets for the current period to be Rs. 412,538,000. Applying the chosen percentage, 2%, to the benchmark amount, Rs. 412,538,000, gives Rs. 8,250,760.

2.40 The engagement team consequently determines materiality for entity D to be Rs. 8,250,000.

Example 5

2.41 Entity E is a listed entity that provides environmentally sustainable garbage disposal. The entity has experienced profit and losses alternatively in the past years. It has been investing heavily in fixed assets over the past years and this has been financed ongoing through borrowing. The main focus of the readers of the entity's financial statements is net assets and the engagement partner has therefore determined that this is the most appropriate benchmark to use in determining materiality.

2.42 Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 2% to be applied to the chosen benchmark. The engagement team has estimated net assets for the current period to be Rs. 35,702,000. Applying the chosen percentage, 2%, to the benchmark amount, Rs. 35,702,000, gives Rs. 714,040.

2.43 The engagement team consequently determines materiality for entity E to be Rs. 725,000.

Example 6

2.44 Another engagement team is in the process of determining materiality for entity F. The entity is a privately owned entity in the forestry business. Both revenue and profit before tax varies significantly between years due to the fact that the optimal timing for harvesting the trees depends both on the current market price of timber and related products and the availability of appropriately mature trees for harvesting. The entity has significant external debt. Due to these circumstances, the engagement partner has determined that the most appropriate benchmark to use in determining materiality is net assets.

2.45 Engagement risk has been determined as normal. Using professional judgment the engagement partner has chosen 3% to be applied to the chosen benchmark.

2.46 The engagement team has estimated net assets for the current period to be Rs. 12,850,000. Applying the chosen percentage, 3%, to the benchmark amount, Rs. 12,850,000, gives Rs. 385,500.

2.47 The engagement team therefore determines materiality for entity F to be Rs. 400,000.

Example 7

2.48 Entity G is a non listed entity that sells high-end clothing in three different stores located in the same city. The brand is well established since several years back. Some control deficiencies have been identified in the past but the engagement team has assessed its internal control as effective overall. There have been no significant changes in the entity's business, management or internal control during the period. The entity has some external debt and engagement risk has been determined as normal. Since the entity is a profit-oriented entity the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.49 Using professional judgment, based on knowledge of the users of the entity's financial statements it, the engagement partner has chosen 10% to be applied to the chosen benchmark.

2.50 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 5,600,000. Applying the chosen percentage, 10%, to the benchmark amount, Rs. 5,600,000, gives Rs. 560,000.

2.51 The engagement team consequently determines materiality for entity G to be Rs. 560,000.

Example 8

2.52 Entity I deal in antiquities. Goods are acquired through purchases of estates, attending auctions and people bringing items to the store. Sales are made through the entity's store, website and at antiquity fairs. The business is privately owned and managed by the owner. The entity has considerable values tied in its inventory, which is partly very slow moving. Revenue and profit has been relatively stable throughout the years. The entity has some external debt but is primarily financed through retained earnings. Engagement risk has been determined as normal and there have been no significant changes in the entity's business, management or internal control. Since the entity is profit-oriented, profit or revenue could be relevant benchmarks in determining materiality for the entity. Due to the significance of the entity's inventory, net assets could also be a relevant benchmark. Using professional judgment, based on these circumstances and knowledge of the users of the entity's financial statements, the engagement partner has decided to consider all these benchmarks in determining materiality.

2.53 The engagement team estimated revenue, profit before tax from continuing operations and net assets for the current period and made the following calculations:

- Profit before tax from continuing operations: 10% of Rs. 460,000=Rs. 46,000
- Revenue: 0.026 x Rs. 5,880,000=Rs. 152,880 (factor applied based on professional judgement)
- Net assets: 3% of Rs.2,000,000=Rs. 60,000
- The average of the three criteria above is Rs. 86,293.

2.54 Considering the amounts calculated above and using professional judgment the engagement partner sets materiality to be Rs. 80,000.

Example 9

2.55 Entity J is a wholly owned subsidiary of an entity which is an audit client and is subject to statutory audit. The entity functions as a sales channel for products manufactured by other group entities. All financing and debt of the entity is provided by the parent and the parent has confirmed in writing that there is no intention of disposing of entity J. Engagement risk has been determined as normal, the entity has a history of few misstatements and the engagement team has assessed its internal control as effective. Being a profit-oriented entity the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.56 The engagement team has estimated the profit before tax from continuing operations for the current period to Rs. 62,350,000. In determining which percentage to apply to the chosen benchmark the engagement partner considers that the entity has the characteristics that allows the engagement partner to apply a larger percentage to the benchmark amount and knowledge of the readers of the entity's financial statements and decides to apply 15% to the benchmark amount. Applying the chosen percentage, 15%, to the chosen benchmark, Rs. 62,350,000, gives Rs. 9,352,500.

2.57 The engagement team therefore determines materiality for entity J to be Rs. 9,250,000.

Example 10

2.58 Subsidiary K of the same group as entity J above has the same main characteristics with the exception that it is financed through external debt that is not guaranteed by the parent entity, as well as share capital. As for entity J, the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations. However, due to the external debt, the engagement partner decides to apply a lower percentage, 7.5%, to the benchmark amount.

Example 11

2.59 Entity L is an entity for which the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations (and applies 5% to this benchmark). Due to entity L's very long production cycle, and dependence on few large products, the entity's profit varies significantly between periods. The engagement partner has, therefore, determined a need to normalise the benchmark amount by using an average of the current period and the four preceding periods.

2.60 The current period's estimated profit before tax from continuing operations is Rs. 11,000,000 and for the prior periods Rs. 907,782, Rs. 9,838,760, Rs. 635,361 and Rs. 7,099,304. The engagement team did not identify any trends to consider in normalising the benchmark amount. 5% of the average benchmark amount of Rs. 5,533,129, is Rs. 276,656.

2.61 The engagement team therefore determines materiality for entity H to be Rs. 300,000.

Example 12

2.62 Entity M is an entity for which the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations (and applies 8% to this benchmark). The estimated profit before tax from continuing operations for the period is Rs. 20,000,000. This amount includes Rs. 5,000,000 which entity M was awarded in damages in a court case. Since the current period estimated profit includes an amount that significantly increases it and the amount is of an extraordinary nature, the engagement partner decides to normalise the benchmark amount by excluding the damages from the current period profit.

2.63 The normalised estimated profit before tax from continuing operations is Rs. 15,000,000. Applying 8% to the normalised benchmark amount gives Rs. 1,200,000.

2.64 The engagement team consequently determines materiality for entity M to be Rs. 1,200,000.

Example 13

2.65 Entity N is a listed entity providing cable, phone and internet services. 49% of the entity's shares are state-owned. Materiality has been set to Rs. 9,830,000 based on 7.5% of estimated profit before tax from continuing operations.

2.66 Due to recent media coverage of a competitor's failure to appropriately disclose salaries and benefits to management, the engagement partner expects users of entity L's financial statements to pay more attention to the disclosure of remuneration of management for the next couple of years than they have in the past. In preliminary discussions with a member of the audit committee a heightened interest in this disclosure was expressed. Due to this fact, the engagement partner determines to set materiality for the disclosure of remuneration of management to half of the materiality for the financial statements as a whole amount, Rs. 500,000.

Documentation

2.67 Audit documentation broadly refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

2.68 Working papers: -

- Aid in the planning and performance of the audit.
- Aid in the supervision and review of the audit work; and
- Provide evidence of the audit work performed to support the auditor's opinion.

2.69 As defined in paragraph 6(a) of SA 230(Revised), Audit Documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work-papers" are also sometimes used).

2.70 Paragraph 14 of SA 320(Revised) states as follows:

"The audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole;

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;

(c) Performance materiality; and

(d) Any revision of (a)-(c) as the audit progressed."

2.71 Thus, the documentation is based on the consideration of the amounts and the factors in their determination. The consideration as pronounced in the Standard and discussed in the earlier paragraphs in connection with the planning the audit and meeting the requirements in connection with the following are to be kept for recording audit procedure performed, relevant audit evidence obtained, and conclusion the auditor reached in the commonly used terms as working papers.

Materiality for the Financial Statements as a Whole

2.72 The auditor determines materiality for the financial statements as a whole while establishing the overall audit strategy. The auditor should determine the materiality levels to be applied to particular classes of transaction, account balances, or disclosures for which misstatement of lesser amounts than the materiality of the financial statement as a whole could reasonably be expected to influence the economic decision of the users taken on the basis of financial statements.

2.73 The question of materiality arises at various stages during the course of an audit. Thus, the auditor is concerned with materiality when: -

- Determining the nature, timing and extent of audit procedures
- Evaluating the effect of misstatement in the measurement and classification of accounts; and
- Determining the appropriateness of presentation of financial information

2.74 The assessment of materiality is a matter of professional judgment. Judgments about materiality are taken in the light of the surrounding circumstances, and are affected by the magnitude or nature of a misstatement, or a combination of both. Therefore, consideration of materiality embeds the qualitative considerations along with the numerical attributes of the information.

Chapter 3

Evaluating the Results of the Tests of Details

Accomplishment of Test Objectives

3.1 After completing tests of details, the results are evaluated to determine if test objectives have been accomplished. Evaluation of results of the tests of details performed depends on:

- Whether Misstatements were detected; and
- The type of Tests of Details used by the auditor.

Quantitative Evaluation

3.2 The quantitative evaluation is primarily related to the amount of misstatement found or estimated to exist in the Population.

3.3 Auditor is required to accumulate misstatements identified during the audit, other than those that are clearly trivial. As such, misstatements detected by a particular test of details which exceed the 'clearly trivial threshold' or are qualitatively significant, are accumulated.

3.4 A quantitative evaluation without due consideration of qualitative aspects may be meaningless if the qualitative evaluation indicates misstatements with suspicious or unusual aspects or misstatements that suggest a particular condition in a portion of the Population.

3.5 For example, if the qualitative evaluation indicates that some population items have different characteristics and, therefore, audit sampling would not be appropriate to test the Population as a whole.

Qualitative Evaluation

3.6 The qualitative evaluation may address the following issues:

- Do the discovered misstatements contain suspicious or unusual aspects that may indicate fraud or error?
- Is there a pattern of Misstatements that may indicate that the population ought to have been defined as two or more populations (e.g., there are misstatements in inventory items at one location, while inventory items at other locations are correct)?
- Has management confirmed that apparent misstatements are, in fact, misstatements and explained their causes?

Evaluating the Results of the Tests of Details

3.7 How an auditor evaluates the results of the Tests of Details performed depends on whether factual misstatements were detected when he examine and evaluate the evidence for items selected for the tests of details.

3.8 The type of tests of details used.

If factual misstatements were identified, the auditor is required to individually assess them, whether or not corrected by management, in order to obtain an adequate understanding of their nature and cause and their possible effect on the particular audit objective and on other areas of the audit. Based on his understanding of their nature and cause, he may need to reconsider audit evidence obtained and plan to perform further audit procedures in order to meet test objectives.

Tests of All Items in the Population

3.9 If an auditor used tests of all items in the population, the misstatement in the population is equal to the amount of factual misstatement that he detected while performing our tests of details.

Non-representative Selection

3.10 If an auditor used non-representative selection, the misstatement in the total population cannot be determined only from the non-representative selection. This is because, based on the Non-representative Selections, he can only form a conclusion with respect to that portion of the population to which those audit procedures were applied to. For that portion of the population, the Misstatement is equal to the amount of factual misstatement that he detected while performing those tests of details.

Audit Sampling

3.11 For tests of details, auditor shall project misstatements found in the sample to the population. An auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

3.12 This projection is performed regardless of whether the audit sample was statistically based or not. The results of the examination of the sample items are evaluated in order to form a conclusion about the population as a whole.

3.13 The purpose of an audit sample is to draw inferences about the entire population based on the results of our tests of selected items. Therefore, if an auditor detect factual misstatements using Audit Sampling, he calculates a projection of the probable misstatements in the total population based on sample findings. This projection forms his best estimate of misstatement in the sampled population. He then subtracts the factual misstatements found in the audit sample from the projected misstatement to determine the extrapolated misstatement in the population tested.

3.14 A Factual Misstatement in an audit sample is not ordinarily an isolated, although by focusing on the type of misstatement, it may be possible to identify a portion of the population most likely to be subject to that type of misstatement and separately test and evaluate this portion of the population.

Anomalous Misstatements

3.15 When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

3.16 In the extremely rare circumstances when an auditor considers a misstatement or deviation discovered in a sample to be an anomaly, he is required to obtain a high degree of certainty that such misstatement or deviation is not representative of the population. He is required to obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

3.17 For example, an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown (e.g., by examining specific transactions processed on that day) and considers the effect of the cause of the breakdown on audit procedures and conclusions.

3.18 For example, a misstatement that is found to be caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomaly, the auditor needs to determine whether the correct formula has been used at other branches.

Evaluating Results of Audit Sampling

3.19 Auditor is required to evaluate the results of the sample to determine whether the use of Audit Sampling has provided a reasonable basis for conclusions about the Population that has been tested.

3.20 For Tests of Details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further Audit Evidence that no material misstatement exists.

3.21 The projected misstatement plus anomalous misstatement, if any, is auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than his expectations of misstatement used to determine the sample size, he may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps him to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional Audit Evidence is obtained.

3.22 Tolerable misstatement may be the same amount or an amount lower than performance materiality. An auditor however typically set tolerable misstatement equal to performance materiality.

Appendix 1

SA 320(REVISED)

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

Contents

Appendix

Standard on Auditing (SA) 320 (Revised), “Materiality in Planning and Performing an Audit” should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the authority of SAs and SA 200 (Revised), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450[1], explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. 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:

   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
   - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.

4. The auditor's determination of materiality is a matter of professional

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[1] SA 450, "Evaluation of Misstatements Identified during the Audit".

[2] For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

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:

(a) 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;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

5. 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, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.[3]

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the SAs, 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.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine 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 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. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

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[3] SA 450, paragraph A16.

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:

    (a) Materiality for the financial statements as a whole (see paragraph 10);

    (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);

    (c) Performance materiality (see paragraph 11); and

    (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

* * *

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.[4] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level[5]. 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 risks of material misstatement and detection risk[6]. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement[7];

(b) Determining the nature, timing and extent of further audit procedures[8]; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report[9].

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

A2. 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:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- 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 or net assets);
- 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;

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[4] SA 200 (Revised), paragraph 11.
[5] SA 200 (Revised), paragraph 17.
[6] SA 200 (Revised), paragraph 13(c)
[7] SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".
[8] SA 330, "The Auditor's Responses to Assessed Risks".
[9] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

- 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.

A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. 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. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. 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:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).

- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may

be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained

Limited Revision Consequential to issuance of the Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit"

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 230 (Revised), "Audit Documentation"

A17. ….Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with SA 320(Revised)[10], assessed risks, significant matters noted during the audit, and conclusions reached.

SA 260 (Revised), "Communication with Those Charged with Governance"

A15. Communication regarding the planned scope and timing of the audit may:

(a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures …

A17. Matters communicated may include:

- The application of the concept of materiality in the context of an audit.

[10] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

SA 300 (Revised), "Planning an Audit of Financial Statements"

Appendix

Considerations in Establishing the Overall Audit Strategy

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of ~~appropriate~~ materiality ~~levels~~ in accordance with SA 320 (Revised),[11] and, where applicable: ~~including:~~
  - ~~o setting materiality for planning purposes~~
  - ~~Setting~~ Determination of materiality for components and communication ~~g materiality for~~ thereof to component auditors ~~of components.~~
  - ~~o Reconsidering materiality as audit procedures are performed during the course of the audit.~~
  - Preliminary identification of ~~material~~ significant components and material classes of transactions, account balances and disclosures.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

A1. The understanding establishes a frame of reference within which the auditor plans to audit and exercise professional judgment throughout the audit, for example, when: …

- ~~Establishing~~ Determining materiality in accordance with SA 320(Revised) ~~and evaluating whether the judgment about materiality remains appropriate as the audit progresses;~~[12] ~~…~~

SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

A94. Ordinarily, a range that has been narrowed to be equal to or less than ~~the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement, and designing further audit procedures~~ performance materiality is adequate for the purposes of evaluating the reasonableness

[11] SA 320 (Revised), "Materiality in Planning and Performing an Audit".
[12] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

of management's point estimate.

A122. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

Appendix 2

SA 450
EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Contents

Appendix

Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"

Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified during the Audit" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of SAs and SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)[1] deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320(Revised)[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to evaluate:

(a) The effect of identified misstatements on the audit; and

(b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material

[1] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraphs 10-11.
[2] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

(b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

(a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised). (Ref: Para. A5)

7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation[3].The auditor shall request management to correct those misstatements .(Ref: Para. A7-A9)

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that

[3] SA 260 (Revised), "Communication with Those Charged with Governance", paragraph A4.

understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)

(b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance[4] uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representation

[4] In accordance with the paragraph 9 of SA 260 (Revised), "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)

(a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

(b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

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Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

A1. Misstatements may result from:

(a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(b) An omission of an amount or disclosure;

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and

(d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in SA 240 (Revised).[5]

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[5] SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320 (Revised), and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530 (Revised)[6].

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised), there may be a greater than an acceptably low level of risk that possible undetected

[6] SA 530 (Revised), "Audit Sampling", paragraphs 14-15.

misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.[7]

A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's

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[7] SA 530 (Revised), paragraphs 5(c) and (d).

judgments[8], which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A11. The auditor's determination of the materiality in accordance with SA 320 (Revised) is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 (Revised) based on the actual financial results.

A12. SA 320 (Revised) explains that, as the audit progresses, the materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially[9]. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320(Revised) (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate[10].

A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification

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[8] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

[9] SA 320 (Revised), paragraph 12.

[10] The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.

misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;

- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720[11] deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

  These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A17. SA 240 (Revised)[12], explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be

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[11] SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".
[12] SA 240 (Revised), paragraph 35.

affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 12)

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[13]

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. SA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).[14] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We

[13] SA 260 (Revised), paragraph 9.
[14] SA 260 (Revised), paragraph 12(c)(iii).

do not agree that items ………and …………… constitute misstatements because [*description of reasons*].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor’s documentation of uncorrected misstatements may take into account:

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

Material Modifications to ISA 450, “Evaluation of Misstatements Identified during the Audit”

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.