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SRI LANKA AUDITING STANDARD 320

AUDIT MATERIALITY

Introduction

The auditor should consider materiality and its relationship with audit risk when conducting an audit.

Materiality

Materiality is defined in the ICASL's framework for preparation of financial statements as follows.

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut off point rather than being a primary qualitative characteristic which information must have if it is to be useful".

Materiality (Contd.......)

- The assessment of what is material is a matter of professional judgment. It is based on the auditors perception of the common financial information needs of the users of financial statements.

- As a result, no specific guidance is provided in the auditing standards for use as a starting point. However income from continuing operations is often used in practice as having the greatest significance to financial statement users.

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Materiality (Contd.......)

- In designing the audit plan the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered.

- The auditor needs to consider materiality at both the overall financial statement level and in relation to classes of transactions, account balances and disclosures.

Materiality (Contd.......)

- Materiality for the financial statements as a whole is based on the auditors professional judgement as to the highest amount of misstatements that could be included in the financial statements without affecting the economic decisions taken by a financial statement user.

- In some cases, there may be a need to identify misstatements of lesser amounts than overall materiality that would affect the economic decisions of financial statement users. This could relate to sensitive areas such as compliance with laws regulations, related party disclosures etc. In the above circumstances materiality levels for particular classes of transactions, account balances, disclosures need to be determined.

Materiality (Contd.......)

- Materiality should be considered by the auditor when,

  (a) Determining the nature, timing and extent of audit procedures, and

  (b) Evaluating the effect of misstatements

- The auditor's understanding of the entity and its environment helps the auditor in assessing the risk of material misstatement of financial statements and responding to those risks throughout the audit.

The Relationship between materiality and audit risk

- The auditors assessment of materiality, related to classes of transactions, account balances, and disclosures, helps the auditor decide such questions as what items to examine and whether to use sampling and substantive analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risks to an acceptably low level.
- There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa.

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The Relationship between materiality and audit risk

- The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures.
- If, after planning for specific audit procedures the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this either,

The Relationship between materiality and audit risk

(a) Reducing the assessed risk of misstatement, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control: or,

(b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and audit risk in evaluating audit evidence

- The auditors assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditors knowledge as a result of performing audit procedures.

Evaluating the effect of misstatements

- In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting frame work, the auditor should asses whether the aggregate of uncorrected misstatements that have been identified during the audit is material.

Evaluating the effect of misstatements (Contd.............)

- The aggregate of uncorrected misstatements comprise,
  (a) Specific misstatements identified by the auditor.

  (b) The auditor's best estimate of other misstatements which can not be specifically identified.

Evaluating the effect of misstatements (Contd.............)

- The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting the management to adjust the financial statements.
- In any event, management may want to adjust the financial statements for the misstatements identified.

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Evaluating the effect of misstatements (Contd.............)

- If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatement is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with SLAUS 700.

Communication of errors

- If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with SLAUs 260.

Thank you.