Step 3: Materiality PP and AR

What do we mean when we regard something as material for us?

Materiality Concept

We use concept of materiality in our daily life decisions

Can you think of some examples?

DEFINITION

"**A** misstatement or **the aggregate** of all misstatements in financial statements,

is considered to be material if,

it is probable that the decision, of a person who

- is relying on the financial statements and **who has a reasonable knowledge of the business and economic activities** (user)

would be changed or influenced by such misstatements or the aggregate of all misstatements."

"In my opinion these financial statements present fairly (or give a true and fair view) in all material respects, the financial position of (entity)."

CONSIDERATIONS FOR DETERMINING MATERIALITY

The **value** of the misstatement.

The **nature** of the misstatement.

The **context** in which the transaction occurs

- Materiality in the last two cases is likely to be much lower than planning materiality, but even small error or misstatement leads automatically to the need to consider qualification.

VALUE OF MISSTATEMENT

Materiality by value is the highest level of misstatement that can be tolerated without affecting the decision of the users.

Two ways to arrive on a materiality level by value

Percentage range of total

Absolute size

NATURE OF MISSTATEMENT

An item (or group of items) may render a matter material because of its inherent **nature or characteristics** rather than its value – for example

where the law or regulation requires it to be disclosed separately regardless of the amount involved.	errors in amounts for which the reader might reasonably expect to find a high degree of precision (e.g. an amount that should equate to a figure in another account);	expenditure required to be authorized in advance by the Ministry of Finance but failing to have been so authorized;

CONTEXT OF THE TRANSACTION

- *transform a balance to be surrendered into an excess vote or vice versa*

- *turn a surplus into a deficit or vice versa;*

- *increase losses above the limits for disclosure;*

- *increase the excess on an expenditure head above the threshold that requires an explanation in the account;*

OTHER FACTORS FOR MATERIALITY

- In addition to three main factors above, the following factors are generally used by auditors in making materiality judgment with by value, natur

  - Th

  ## ½ % for Very Sensitive
  ## 1% for Sensitive
  ## 2% for not Sensitive

NATURE OF MATERIALITY

It should be noted that materiality is a subjective concept as it applies to a wide variety of financial statement users who have a wide variety of interests.

Many auditors wish that definitive, quantitative materiality guides could be issued, but many also fear the rigidity of such guides.

Auditors, however, are generally left without definitive, quantitative guidelines.

ROLE OF MATERIALITY

The materiality level set to determine the amount of audit effort.

At the planning stage, materiality by value is likely to be the main determinant.

- PLANNING STAGE

The judgement is guided by

- using percentage range limits *(0.5% to 2%)*
- Absolute size: Fixing an amount above which every thing is considered material *(any error above 50 million)*

ROLE OF MATERIALITY

- REPORTING STAGE

In the **Reporting stage** materiality serves as a measure for evaluating the **aggregate of the misstatements.**

The auditor concludes that the **maximum possible misstatement** in the financial statement at the desired level of **assurance** is less than **materiality**

Materiality also involves **qualitative** considerations at this stage.

AUDIT RISK AND MATERILAITY

The auditor is concerned with material misstatements, and <u>is not responsible</u> for the detection of misstatements that are not material to the financial statements taken as a whole.

To determine whether there are misstatements material to the financial statements taken as a whole, the auditor considers the risk of material misstatement at two levels:

- the overall financial statement level and
- in relation to classes of transactions, account balances, and disclosures and the related assertions.

RECAP

Relation to

financial ....

Definition

An error is material if the error is big enough to influence the users of the financial statements.

Applicable	Factor	Base Amount	%	Materiality Amount
	Percentage of total expenditures (usual range is 2% for "small" entities to 0.5% for "large" entities)			
	Percentage of total revenue (usual range is 2% for "small" entities to 0.5% for "large" entities)			
	Percentage of normalized pre-tax income (usual range is 5% for entities with "large" pre-tax incomes to 10% for entities with "small" pre-tax incomes)			
	Percentage of equity (1% often suggested)			
	Percentage of assets (0.5% often suggested)			
	Other information (base amount) (please specify) _____			