JMC vLearning
"your virtual learning partner"

SLAuS 320 : Audit Materiality

AAT Level III

Financial Control & Audit
(FCA)

Nilantha Weerasinghe
ACA, B.Sc. (Accounting and Finance)

JMC JAYASEKERA MANAGEMENT CENTRE (PVT) LTD Estd. 1972

JMC Jayasekera Management Centre (Pvt) Ltd
Pioneers in Professional Education
65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

9. AUDIT MATERIALITY (SLAuS 320)

9.1 Introduction

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

"Materiality"

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.

9.2 Materiality

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The assessment of what is material is a matter of professional judgment.

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 the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.

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

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.**

9.3 The Relationship Between Materiality and Audit Risk

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.

The auditor would reduce the audit risk by:

(a) Reducing the assessed risk of material 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.

9.4 Evaluating the Effect of Misstatements

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

The **aggregate of uncorrected misstatements comprises:**

(a) Specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and

(b) The auditor's best estimate of other misstatements which cannot be specifically identified (i.e., projected errors).

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 management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.

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 misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with SLAuS 700, "The Auditor's Report on Financial Statements."

If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing audit risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

9.5 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 "Communication of Audit Matters with Those Charged with Governance."

JMC, 65/2A, Chittampalam Gardiner Mw., Colombo 02. Tel: 0112- 430451, 0115-755600/1