KHILJI & CO. Chartered Accountants

# KCO BLOGS 2020

This blog is written by **Mr. Zahid Mehmood, FCA, FCCA, Partner Khilji & Co.** Please read this blog and provide your valued comments

## MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

**What is the concept of materiality in the context of financial statements?**

The overall materiality at the financial statement level is determined by the auditor at the planning stage and when performing the audit and evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements.

Based on materiality, the performance materiality and a clearly trivial threshold is calculated which is turn used to help the auditor design audit procedures and accumulate misstatements respectively.

Generally, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

**The calculation of materiality**

Ordinarily there are three key steps:

- **Choosing the appropriate benchmark;** e.g. based on revenue, total expenses, total assets, net assets or any other appropriate benchmark according to specific circumstances of the entity.
- **Determining a level;** which is usually a percentage between 1% to 5% of this benchmark; and
- **Justifying the choices;** i.e. explaining the reason for choosing the specific benchmark and percentage applied. Judgement about materiality are made in the light of surrounding circumstances and are affected by auditors' perceptions of the financial information needs of users of the financial statements, and by the size, nature of a misstatement or both size and nature.

The different level of materiality may be set for account balances which are more sensitive; e.g. related party balances.

**Choosing the appropriate benchmark:**

Although it is judgmental, however, below are some of the factors which may be considered while selecting the appropriate benchmark;

***Based on revenue or profit before tax*** more suits the commercially managed organisation depending the volatility.

***Based on total expenses*** more suits the charitable organizations where the income is volatile, however, expenses are normally more consistent.

***Based on total assets or net assets*** more suits an investment property entity where the assets value is higher than income statement. Based on net assets also suits a start-up organisation where there is no / limited revenue.

***Based on total expenses*** more suits the charitable organizations where the income is volatile, however, expenses are normally fixed.

**Performance materiality**

Performance materiality sets a numerical level which helps guide auditors to do enough work to support audit opinion. Normally it is a percentage of materiality.

It helps to reduce the aggregation risk (the risk that the aggregate of uncorrected and undetected misstatements individually below materiality will exceed materiality for the financial statements as a whole) to an acceptable level; and to provide a safety net against the risk of undetected misstatements.
The level of performance materiality among other judgemental factors also depends on control environment which exists in the Company.

Performance materiality is used in the planning stage, to help to identify what areas need to be audited and how much and what type of work is needed; and during the early fieldwork stage (arguably still part of the planning) in identifying more precisely which items need to be tested including sampling and how many items to include in the sample.

The items of financial statements which are below performance materiality are normally treated as insignificant account balance while the items above are treated as significant account balances. For insignificant balances, the auditor may document the nature of account balance. For items which are equal or slightly above performance materiality, the auditor may carry out analytical procedures. For items significantly above, the auditor may perform test of details. There are some account balances where the nature is more important the amount, the auditor should consider this factor while selecting for testing based on the above criteria.

**Tolerable misstatement**

Tolerable misstatement is based on percentage of materiality and is applied to the selection and evaluation of results when sampling.

**ZAHID MEHMOOD, FCA, FCCA**
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