Materiality and Audit Evidence

Materiality

- Materiality underlies the application of auditing standards and thus has a pervasive effect in a financial statement audit.
- Auditors must consider materiality in planning the audit and evaluating the extent of material misstatements.
- AASB 1031 'Materiality' and states that materiality means: … that information which, if omitted, misstated or not disclosed, has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by the management, including the governing body of the entity …

- Auditing Standard ASA 320 Materiality and Audit Adjustments, addresses materiality from an audit perspective.
- In auditing, materiality pertains to the extent of misstatements (uncorrected errors, erroneous disclosures or omissions) that exist in the financial statements.
- Auditors plan and execute audits with a reasonable expectation of detecting material misstatements.
Materiality

- Auditing Standard ASA 320 Materiality and Audit Adjustments, addresses materiality from an audit perspective
- Materiality applies to both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial report
- Auditors plan and execute audits with a reasonable expectation of detecting material misstatements

Materiality

- The assessment of what is material is a matter of the auditors’ professional judgment of the needs of the reasonable person relying on the information
- There is an inverse relationship between materiality and audit risk
- Where the auditor considers there is a higher risk of misstatement, materiality will be set at a lower level

Quantitative guidelines

- AASB 1031 provides some quantitative threshold guidance to assist in determining materiality
- Also highlights the importance of professional judgement, characteristics of the entity, and perceptions of the likely users’ information needs in making a materiality determination
- The following guidance is provided:
  - an amount that is equal to or greater than 10% of the appropriate base amount is presumed to be material
  - an amount that is equal to or less than 5% of the appropriate base amount is presumed not to be material
  - Logically following from the above, whether an amount between 5% and 10% is material is a matter of judgement
Qualitative guidelines

- Relate to the causes of misstatements or to misstatements that do not have a quantifiable effect
- A misstatement that is quantitatively immaterial may be qualitatively material
- Examples of qualitative misstatements are:
  - an inadequate or improper description of an accounting policy
  - a failure to disclose a breach of regulatory requirements
  - a change in accounting method which is likely to affect materially the results of subsequent financial years
  - corporate fraud
  - a related party transaction or event requiring disclosure

Audit strategies

- The audit strategy taken is an important decision that significantly affects the detailed work performed in the audit
- The interrelationship amongst evidence, materiality and the components of audit risk affects the auditor’s decision on the type of strategy chosen
- If the auditor assesses that appropriate controls do not exist or are likely to be ineffective, then a predominantly substantive approach will be adopted
- Substantive procedures are those that substantiate the amounts recorded in the financial statements, and they are normally costly to perform

Audit strategies

- A more efficient audit can be performed if controls are judged to be effective enough to enable a reduction in the level of substantive procedures undertaken
- An audit strategy that relies on internal controls to support the use of a reduced level of substantive procedures is sometimes referred to as a lower assessed level of control risk approach
- This is not a single strategy, but a range of strategies determined by the relative effectiveness of applicable control procedures (combined with assessments of inherent risk and materiality)
Audit strategies

- The auditor must make four separate decisions before adopting such a strategy, and each decision (except the first) must be supported by relevant evidence:
  1. Is it cost-effective to adopt a lower assessed level of control risk strategy?
  2. Are control procedures effectively designed?
  3. Are control procedures effectively operated?
  4. Do the results of substantive procedures confirm the assessment of control risk?

The relationship between strategies and transaction classes

- The strategies are not intended to characterise the approach to an entire audit
- Represent alternative approaches to auditing individual assertions
- Often, however, a common strategy is applied to groups of account balance assertions affected by the same transaction class

The relationship between strategies and transaction classes

- The rationale is that many internal controls focus on the processing of a single type of transaction
- Double entry means that each transaction class affects two or more account balances
- *For example, sales transactions relate to accounts receivable in the balance sheet and to sales in the profit and loss account*
Preliminary audit strategies for material financial statement assertions

Audit evidence

- Audit evidence is a fundamental concept in auditing by which the auditor achieves the objective of reasonable assurance that none of management’s assertions is materially misstated, and consists of:
  - underlying accounting data
  - all corroborating information available to the auditor

- Underlying accounting data includes:
  - books of original entry
  - general and subsidiary ledgers
  - related accounting manuals

- Also includes informal and memorandum records, such as worksheets, calculations and reconciliations

Audit evidence

- Corroborating information
  - Documents such as cheques, authorisations for direct bank transfers, invoices, contracts etc.
  - Confirmations and other written representations
  - Information from inquiry, observations, inspection and physical examination
  - All other information obtained or developed by the auditor
The auditing standard pertaining to evidence

• ASA 500 on Audit Evidence states:
  – The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion
  – The standard specifies that ‘sufficient’ (enough), ‘appropriate’ (relevant and reliable), audit evidence should be obtained to provide a ‘reasonable’ (rational) basis for an opinion

Sufficiency of audit evidence

• Relates to the quantity of audit evidence
• Factors that may affect the auditor’s judgement of sufficiency include:
  – materiality and risk
  – economic factors
  – the size and characteristics of the population
• In general, more evidence is needed for accounts that are material to the financial statements

Appropriateness of audit evidence

• Relevance means that evidence must be sufficient with respect to each of the auditor’s objectives
• The reliability of evidence is influenced by factors such as the source and nature of the information, and its timeliness and objectivity
• The auditor is not expected or required to have an absolute, certain or guaranteed basis for an opinion
Types of Evidence

- Analytical
- Confirmations
- Documentary
- Written representations – ASA 520 'Management Representations'
- Mathematical
- Oral
- Physical
- Electronic

In arriving at a professional judgment of reasonable assurance, the auditor is guided by the persuasiveness of the evidence.

Given that professional judgment is involved, different auditors will not always reach identical conclusions about the quantity and quality of evidence needed to reach an opinion on financial statements.

Audit procedures

- Auditing procedures are methods and techniques used by the auditor to gather and evaluate audit evidence.
- In selecting a procedure, the auditor must take care to balance the potential effectiveness of the procedure in meeting specific objectives against the cost of performing the procedure.
Audit procedures

Methods & techniques used by auditor to gather evidence
- Inspection
- Tracing
- Vouching
- Observation
- Enquiry
- Confirmation
- Recalculation
- Re-performance
- Analytical procedures

Many of these procedures can be performed with audit software

Classification of auditing procedures

- Auditing procedures are usually classified by purpose into the following categories:
  - Procedures to assess risks including obtaining an understanding of the internal control structure
  - Tests of controls
  - Substantive procedures

Tests of controls

- Provide evidence about the effectiveness of the design and operations of internal control structure and procedures
Substantive Procedures

• Provide direct evidence as to the fairness of management’s financial statement assertions
• This category of auditing procedure consists of:
  – analytical procedures
  – tests of details of transactions
  – tests of details of balances
• Analytical procedures involve the use of comparisons to assess fairness, e.g. a comparison of an account balance with the previous year’s balance or a budgeted amount

Substantive Procedures

• Tests of details of transactions involve examining support for the individual debits and credits posted to an account
  – Examples include vouching the debits in accounts receivable to entries in the sales journal and supporting sales invoices
• Tests of details of balances involve examining support for the closing balance directly
  – Examples include confirming accounts receivable directly with the customer