MATERIALITY IN THE AUDIT PROCESS

By: Gary A. Porter, CPA and Michelle Pope, CPA

EXECUTIVE SUMMARY

Materiality is an assessment made by a CPA of the amount of tolerable misstatement of a client's financial statements in relationship to the amount of assessed risk assumed, and the perceived users of the report.

Materiality is considered throughout all three stages of an audit; planning, field work, and final analytical procedures.

The materiality assessment determines the extent of audit procedures performed by the CPA.

Financial statements that have been determined to be materially misstated by a CPA must either be adjusted, or the CPA must issue a qualified or adverse opinion.

Materiality is a term that all auditors are familiar with. It is a concept used in all three stages of the audit process; that is, planning, field work, and final analytical procedures and report preparation. Most people who are not familiar with the public accounting profession view an audit as a process where every transaction is verified and evaluated. This is simply not the case. This is where the concept of materiality jumps in.

Materiality is defined as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

This is a subjective assessment made by the CPA, based upon professional judgment, which is influenced by a perception of the needs of a reasonable person who will rely on the financial statements. Sometimes a table of percentages is used as a guideline, which is based on the larger of total assets or total revenue. For example, if total assets are $1 million, and total revenues are $2 million, the base number to start with in planning materiality is the larger amount of $2 million. Materiality could be $9,500 plus a percentage of the base amount within a range of $1 to $5 million.

The CPA must always know the reason for the audit. For example, many audits are required by banks of businesses who have bank loans. In this instance, the CPA knows that the bank will rely on the opinion given in the report. Another business may require an audit based on a decision to sell. The CPA should know that a potential buyer is relying on the opinion report. Many homeowners association CC&Rs require audited year end financial statements, and some boards of directors prefer an audit because it provides a feeling of confidence in their management. Knowing the purpose of the audit helps the CPA determine overall audit risk.

Materiality is necessary because, in order for fees to be reasonable, the CPA must work within economic limits, and the opinion needs to be formed within a reasonable amount of time at a fair cost. If CPAs were required to inspect every document supporting every transaction, proposals or a preliminary estimate of fees could never be given. We would simply have to bill at our hourly rates, and the fees could be sky high. This type of unknown can be shocking when the bill comes in.

In the planning stages of the audit, where approximately one third of the audit work is conducted, the auditor will review a client's current and prior financial statements, budget, and variances, and will make a preliminary assessment of planning materiality, tolerable misstatement, and individually significant items. This concept recognizes that certain matters, either individually or in the aggregate, are more significant than others for the fair presentation of financial statements in conformity with generally accepted accounting principles than others. An auditor's standard unqualified report

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wording will say:

> *"In my opinion, the financial statements... present fairly, in all material respects, the financial position of....in conformity with generally accepted accounting principles."*

This wording expresses the auditors belief that the financial statements as a whole are not materially misstated.

As a CPA performs initial analytical procedures, and begins to ask questions of management, a certain "feel" is developed as to the amount of audit risk involved in the audit. Audit risk is the risk that the auditor may unknowingly fail to modify his opinion on financial statements that are materially misstated. The three types of risk that an auditor considers are inherent risk, control risk, and detection risk.

Inherent Risk is risk associated with a clients particular account types and industry. Higher risks are attributed to accounts involving complex calculations, the needed use of estimates, or perhaps technological advances and its affect on a clients product. These areas are more susceptible to a material misstatement than accounts consisting of relatively routine, factual data, as they are subject to the unpredictability of future events, or the possibility of misapplying appropriate data.

Control Risk is the risk that a material misstatement will not be prevented or detected by the client's internal control structure in a timely manner. Every internal structure has limitations, because they always involve a human element, which has a tendency to be deviant where there is access to assets belonging to others. This is why a proper segregation of duties is important, especially in the areas of receiving and disbursing cash. California recognizes this area of importance with Civil Code Section 1365.5, which requires boards of directors to review bank reconciliations and statements at least quarterly, among other things relating to financial data.

Detection risk is the risk that a material misstatement exists, and the auditor will fail to detect it. This risk is a function of the effectiveness of auditing procedures and their application in the course of an audit. Detection risk is different from inherent risk and control risk, because detection risk is an attribute of the audit, whereas inherent and control risk are attributes of the client under audit.

The level of risk and materiality assessed by a CPA will determine the scope of audit procedures applied to financial data. A CPA knows that the relationship between materiality and audit risk is inverse. Therefore, the higher the risk, the lower the materiality levels used. Materiality will vary with the size and complexity of an entity, the CPA's experience with the entity, and his knowledge of the client's industry.

Generally, it takes a lot of work to make a proper assessment of inherent and control risk. In fact, it may be less efficient to make a proper assessment of these risks than to assume a maximum risk and extend the auditing procedures performed in the field. CPAs assess risk in order to determine the scope of auditing procedures. With smaller clients, that have few account balances and transactions during a fiscal year, it is often more efficient to look at all or most of the transactions that took place, and assume that risk is at maximum. In each audit, a CPA must weigh the cost of audit procedures with the expected benefit to be gained from those procedures.

In the final stages of the audit, the CPA will aggregate all of the misstatements, usually on a "Passed Adjustments" list, to determine whether or not all of the misstatements that were individually immaterial cause the financial statements to be materially misstated as a whole. If the auditor determines that the financial statements are misstated as a whole, then the misstatements must be adjusted, and if not made, then a qualified or adverse opinion on the financial statements would need to be rendered. If the financial statements are not materially misstated, even with some variation between actual balances and balances reported, an unqualified opinion may be rendered.

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