AUDIT RISK, MATERIALITY AND THE PROFESSIONAL JUDGEMENT OF THE AUDITOR

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Abstract: *This paper refers to the auditor's professional judgement concerning audit risk and materiality; the opinion the author would like to highlight contains interpretation of Statement on Auditing Standards (SAS) No. 107, Audit Risk and Materiality in Conducting the Audit; Staff Accounting Bulletin No. 99, Materiality; SAS No. 47, Audit Risk and Materiality in Conducting an Audit, document amended by SAS No. 82, Consideration of Fraud in a Financial Statement Audit.*

One aspect of importance, of this work, is represented by the materiality threshold, whose use arises from the auditor's judgment and the actions an auditor, CPA must follow besides a mathematical measurement.

In March 2006, Statement on Auditing Standards (SAS) No. 107, *Audit Risk and Materiality in Conducting the Audit* was issued to provide the auditor guidance on the consideration of risk and materiality in performing a financial statement audit. Because we mentioned audit risk and materiality, we should first mention some meanings of the materiality term, such as:

• "… if knowledge of the matter would be *likely to influence the user* of the financial or other statements under consideration"[1];

• "… 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 changed or influenced by the omission or misstatement"[2];

• "...the magnitude or nature of a misstatement (including an omission) of financial information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that the judgment of a *reasonable person* relying on the information would have been influenced or one's decision affected, as a result of misstatement"[3];

• "… an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.... a matter is material if its omission or misstatement would reasonably influence the decisions of an *addressee* of the financial statements"[4];

One reason of importance for the materiality threshold is that financial statements are prepared for those outside the company who need the information and who base their financial decisions upon it (e.g., investors).

Consequently, the materiality threshold should be based upon what will *affect* financial statement user' decisions and not upon preparers' arbitrary assessments. These decisions should be based both on *quantitative* as well as *qualitative factors*. For example, even a small amount of fraud committed by company managers would likely be considered to be highly material to financial statement users, who need to assess the integrity of those to whom they have entrusted their assets.

Materiality must be evaluated from the perspective of whether the information under consideration would make a difference to an existing common shareowner's assessment and valuation of the investment. The use of arbitrary quantitative thresholds, such as 5 percent of some income statement number, to assess materiality does not serve investor interests. The author

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[1] *ICAEW, Accounting Recommendation 2.301, 1967*
[2] *FASB, 1980, p. xv*
[3] *International Auditing Practices Committee, International Federation of Accountants, Glossary of Terms, 1991*
[4] *SAS 220, Auditing Practices Board, UK, 1995, paragraph 3*

believes that if there is doubt about materiality, the item should receive separate recognition and measurement, accompanied by sufficient disaggregated disclosure.

Despite statements of regulators, company managers and their auditors tend to apply *ad hoc* "rules of thumb" when deciding whether certain items are of sufficient size or importance (materiality) to warrant clear, separate reporting and the reporting method to be applied.

For example, some managers and auditors may use as their benchmark 5 percent of a line item, such as net income or total assets or sales. In contrast, we believe that materiality assessments should use the standard of *whether the item would make a difference to an informed financial statement user.* For example, a relatively small amount might change the trend of an expense category. Moreover, related items should be considered in total, rather than individually, to determine materiality.

The author would like to highlight the way that materiality threshold is taken in concern in accounting and audit literature:

a) *Professional bodies* suggest that auditors must use mathematical measurements reported to the net profit before tax, such as:

- *If an item/items is/are inside of 5% of net profit before tax: immaterial*
- *If an item/items is/are between 5% to10% of net profit before tax: judgemental*
- *If an item/items is/are greater than 10% of net profit before tax: material*

b) If profit is not a suitable measurement, then the auditor should use either one of the following (depending on the nature of the item)[5]:

- *0.5% to 1% of assets;*
- *0.5% to 5% of equity;*
- *0.5% to 1% of revenue;*
- *0.5% to 5% of gross profit;*
- *0.5% to 2% of total expenses.*

Audit manuals (*Big 4 and non Big 4*) have also suggested items greater than 10% of net profit before tax is considered material. If in doubt concerning materiality threshold, the author suggests using the following samples of academic research on materiality:

PROFIT AND LOSS ITEMS	
(a) 0.2% to 10% of turnover	Plumhoff [1952]; Anderson [1977]; Towers [1986]; Woolf [1994], Turley and Cooper [1991]
(b) 0.5% to 5% of gross profit	Carmichael [1969]

PROFIT	
(c) 0.5% to 36% of net profits	Bernstein [1967,1970]; Copeland and Frederick [1968]; Neumann [1968]; Thomas [1978];Turley and Cooper [1991]
(d) 0.1% to 5% of total assets	Woolf[1994]; Turley and Cooper [1991]

BALANCE SHEET ITEMS	
(a) 10% to 20% of related total	Plumhoff [1952]; Mitchell [1972]; Towers [1986]
(b) 0.5% to 5% of gross profit	Carmichael [1969]
(c) 0.1% to 10% of total assets	Mitchell [1972]; Woolf[1994]; Turley and Cooper [1991]
(d) 10% of total liabilities	Mitchell [1972]
(e) 10% of equity	Mitchell [1972]
(f) 0.2% to 10% of turnover	Woolf [1994]; Turley and Cooper [1991]
(g) 3.3% to 36% of net profit	Turley and Cooper [1991]; Chong [1992, 1993]

[5] *Canadian Institute of Chartered Accountants* (2005)

Staff Accounting Bulletin No. 99, Materiality, represents a restatement of existing concepts of materiality contained in the accounting and auditing literature. Particularly, companies and their auditors are warned not to rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. In SAS No. 47, Audit Risk and Materiality in Conducting an Audit, as that document is amended by SAS No. 82, Consideration of Fraud in a Financial Statement Audit, the Accounting Standards Board had already reached the conclusion that *qualitative considerations* (not just a quantitative threshold) *are important* in concluding whether financial statement misstatements are material. Therefore, it would seem that determining whether items, events, and transactions are material to financial statements never should have been based simply on a "bright-line" quantitative (amount or percentage) materiality threshold.

Staff Accounting Bulletin No. 99 consists of two parts. The first part stipulates that it is not appropriate to rely solely upon a percentage ceiling test to make materiality determinations. Though there is no objection to using quantitative thresholds as an initial assessment, using them exclusively has no basis in the accounting literature or law. The staff emphasizes that evaluation of materiality requires companies and their auditors to consider all relevant circumstances, both quantitative and qualitative, surrounding an issue. Exhibit 1 summarizes some of the qualitative factors discussed in Staff Accounting Bulletin No. 99 that should be considered by auditors in determining whether a misstatement is material to the financial statements.

Exhibit 1: QUANTATIVE MATERIALITY ISSUES

Does the misstatement:

1. *Mask a changing in earnings or other trend?*
2. *Arise from an item capable of precise measurement, or does it arise from an estimate?*
3. *Hide a failure to meet analysis' consensus expectation for the enterprise?*
4. *Chance a loss into income or vice versa?*
5. *Concern a segment of the business that has been identified as playing a significant role in operations or profitability?*
6. *Affect compliance with regulatory requirements?*
7. *Affect compliance with loan covenants or other contractual requirements?*
8. *Have the effect of increasing management's compensation?*
9. *Involve concealment of an unlawful transaction?*

The second part of Staff Accounting Bulletin No. 99 serves as a reminder that accountants should make and keep books, records, and accounts that (in reasonable detail) accurately and fairly reflects transactions and disposition of assets. Staff Accounting Bulletin No. 99 specifically stipulates that managers should not direct or acquiesce in immaterial misstatements in the financial statements for the purpose of managing earnings. Furthermore, the Staff Accounting Bulletin indicates that, above and beyond issues directly associated with amounts in the financial statements, the very practice of managing earnings might be a material fact that must be disclosed. As an example, the Staff Accounting Bulletin indicates that the ongoing practice to over or understate earnings up to an amount just below a defined percentage threshold in order to manage earnings would generally be considered significant to financial statement users.

The Staff Accounting Bulletin also refers to *intentional misstatements*, even if immaterial. Auditors encountering intentional misstatements should consider the guidance in SAS No. 54, Illegal Acts, and SAS No. 82, Consideration of Fraud in a Financial Statement Audit.

Materiality in relation to a misstatement refers to the extent of the misstatement. There are two aspects to materiality - *reporting materiality* and *planning materiality.*

Reporting materiality is concerned with whether a misstatement of a financial statement item, or an aggregation of such misstatements, is likely *to affect the judgement of users of financial statements.*

In the client acceptance stage the auditor evaluates whether, if the client is accepted or retained, the audit risk (the risk of a material misstatement in the audited financial statements) can be reduced to an acceptable level. In this, the initial audit stage, the word "material" refers to the value of reporting materiality. Similarly in the final opinion formulation stage, the auditor evaluates the likelihood of the audited financial statements containing a material misstatement. Again, this evaluation is based on the value of reporting materiality.

The value of reporting materiality is based on such factors as the entity's earnings, total revenue, total assets and equity. This materiality value may remain constant throughout the course of the audit.

For example, the following materiality *guidelines* are used by auditors *to assess reporting materiality:*

1. *Pre-tax income* *5-10%*
2. *Net (or after-tax) income* *5-10%*
3. *Gross revenue* *0.5-1%*
4. *Equity* *5-10%*
5. *Total assets* *0.5-1%*

We must underline that when materiality is determined in the client acceptance/retention stage, pre-tax income and other figures above may only be capable of estimation. Accordingly, the phrase "*estimated reporting materiality*" may be the appropriate term to use.

Where an entity's results are expected to be "normal", then reporting materiality is based on (estimated) after tax income amounts. For example, the starting point for materiality of a "normal" entity with net income of 10,000,000 euro is somewhere between 500,000 euro and 1,000,000 euro. However, where the entity incurs losses, has potential going concern problems or the results are in other ways unusual, materiality may be based on one or more of the other factors referred to above. For example, if the entity is incurring losses, both before and after tax, the auditor may use total assets or total revenue, whichever is the greater. The final assessment of reporting materiality is subjective and depends on the auditor's perception of, for example, what information is relevant, who the users of the financial statements are, what decisions the users may make and what would influence those decisions.

Note that a financial statement item may be materially misstated because of either a quantitative misstatement (in relation to its monetary value) or a qualitative misstatement (in relation to its accuracy of presentation, disclosure, and description).

In this part of the work, the author would like to underline elements concerning materiality threshold, and especially the situations when it’s considered acceptable.

Staff Accounting Bulletin 99 states that insignificant misstatements that result from the normal course of business rather than from an intentional scheme to manage earnings are acceptable and that companies are not required to make major expenditures to correct small misstatements, to conserve small amounts. In contrast, failing to correct misstatements when there is little cost or delay is unlikely to be “reasonable.”

Considered to be not acceptable are the following:

✓ Companies and the auditors of financial statements **should not rely exclusively on quantitative benchmarks** to determine whether items are material to the financial statements. They must consider both qualitative and quantitative factors in assessing the materiality of differences and/or omissions.

✓ **Intentional errors are not acceptable**, regardless of materiality. Levitt addressed this issue when referring to companies that abuse materiality: “They intentionally record errors within a defined percentage ceiling. They then try to excuse by arguing that the effect on the bottom line is too small to matter. If that’s the case, why do they work so hard to create these errors?”

✓ **Intentional misstatements are not acceptable according with the law,** no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account

✓ **Misstatements created with the intent of managing earnings** are not acceptable, regardless of materiality. Accordingly, "It is unlikely that it is ever 'reasonable' for companies to record misstatements or not to correct known misstatements—even immaterial ones—as part of an ongoing effort directed by or known to senior management for the purposes of 'managing' earnings."

✓ Companies and their auditors **should consider each misstatement and its materiality separately and taken together**. The aggregate effect of multiple misstatements cannot be justified by offsetting material misstatements with immaterial ones.

✓ **Qualitative factors may cause small amounts to become material;** the Staff Accounting Bulletin illustrates a number of qualitative factors that management and auditors might consider when evaluating the materiality of misstatements. In a financial statement, a quantitatively small misstatement may become material, Exhibit 1.

Examples of acceptable and unacceptable uses of materiality:

Acceptable:

1. as an initial step in assessing materiality, a quantitative threshold is OK;
2. insignificant misstatements resulting from the normal course of business do not require restatement of a registrant's books;
3. Cost–benefit considerations are a factor in correcting small misstatements.

Not Acceptable:

1. exclusive reliance on quantitative benchmarks in assessing materiality is not appropriate;
2. intentional errors based on materiality are always wrong;
3. intentional misstatements, even if immaterial, violate federal law;
4. Misstatements created for the purpose of managing earnings are unacceptable, regardless of materiality.
5. Quantitatively small misstatements are material under certain circumstances and must be evaluated according to certain qualitative factors.

Auditors need to be able to identify key control exceptions. They also must correctly apply a familiar concept, materiality, to determine the financial impact of such exceptions. This part of the article explains the *four types of key control exceptions* auditors may encounter as well as how to apply materiality to evaluate each one.

THE 5% RULE: For many years auditors have used quantitative estimates to help them identify potentially material transactions and events. Working materiality levels or quantitative estimates of materiality generally are based on the 5% rule, which holds that *reasonable* financial statement users would not be influenced in their investment decisions by a fluctuation in net income of 5% or less. Nor would the investor be swayed by a fluctuation or series of fluctuations of less than 5% in income statement line items, as long as the net change was less than 5%.

Materiality is not a simple calculation. Rather it is a determination of what will against what will not affect the decision of a knowledgeable financial statement user's given a specific set of circumstances related to the fair presentation of a company's financial statements and disclosures concerning existing or future debt and equity instruments. However, because such a qualitative analysis is very complex, auditors also use quantitative estimates to identify potential materiality issues.

The "normal" calculation of the 5% working materiality level takes an company's pretax net income from continuing operations and normalizes it by adjusting for unusual events not anticipated in the current year. Auditors then adjust the estimate for unusual events expected in the current year and use 5% of the year's adjusted net income estimate as the basic working materiality threshold. Errors in the company's books and records that are less than this amount are considered immaterial and do not require financial statement adjustments to obtain an unqualified audit opinion. Errors equal to or greater than this amount require adjustments.

THE FOUR PERSPECTIVES: To assist auditors in helping management meet its responsibilities, there are four perspectives of working materiality, each with its own distinct quantitative calculations and limits. To know which materiality level to apply, auditors must determine the type of financial statement effect or "exception" at hand. The first is familiar to most auditors, the *actual financial statement misstatement or error*. It generally is a euro error that can be calculated exactly. The second exception is an *internal control deficiency* caused by the failure in design or operation of a control. The third, a large variance in an *accounting estimate* compared with the *actual determined amount*. The fourth exception is *financial fraud by management* or other employees to enhance a company's reported financial position and operations results.

Companies must review their disclosure controls and procedures quarterly, identify all key control exceptions and:

1. *Determine which are internal control deficiencies.*
2. *Assess each deficiency's impact on the fair presentation of their financial statements.*
3. *Identify and report significant control deficiencies or material weaknesses to the board of directors' audit committee and to the company's independent auditor.*

EXCEPTION 1 - MISSTATEMENTS OR ERRORS: Many auditors call actual financial statement misstatements or errors *uncorrected/unrecorded misstatements*. Under the normal financial audit process, auditors accumulate and report these euro errors on a similarly named schedule that usually lists two types of financial statement errors:

1. *Incorrectly recorded financial statement amounts.* These transactions generally were recorded incorrectly because they were in the wrong amount or the wrong account.
2. *Financial statement amounts that should have been recorded but were not*.

Generally, the solution to uncorrected/unrecorded misstatements is very easy: management simply adjusts the financial statements. However, when these errors are discovered and whether the company can determine the correct accounting in a timely manner affect its ability to record these entries for the correct reporting period.

In determining working materiality levels for uncorrected/unrecorded misstatements, there are several *generally used methods*. Each is based on the 5% rule as a calculated percentage of that materiality limit. Auditors must undertake appropriate qualitative analysis to determine whether a material misstatement actually occurred, if so, management only needs to appropriately record the uncorrected/unrecorded misstatement.

In reviewing the materiality of uncorrected/unrecorded misstatements, errors can fall in one of three ranges—*inconsequential*, *consequential or material misstatements*. Very small uncorrected/unrecorded misstatements have no consequence on the financial statements and need not be identified or considered but a large number of like errors should be considered as a single error. As a general practice, management should attempt to limit these mistakes and search for and record identified errors.

Since a company's independent auditor usually accumulates uncorrected/unrecorded misstatements and presents them to management and the audit committee quarterly, these misstatements become *consequential* when the auditor includes them on this schedule and reports them to the committee. Having these errors and not adjusting the financial statement means the statements are misstated by the amount of the errors.

An error or aggregation of errors that reaches the 5% rule is a "*material misstatement*" of the financial statements and must be recorded in order for the independent auditor to give an unqualified audit opinion.

EXCEPTION 2 - INTERNAL CONTROL DEFICIENCIES: The second perspective on working materiality levels, an internal control deficiency caused by the failure of a control.

Any internal control failure could be a control deficiency. Such deficiencies usually are the result of a failure in control design or operation. A design failure results when management has not established a sufficient amount of internal control or control activities to achieve a control objective; an operation failure occurs when an adequately designed control does not operate properly, thus these failures can be significant deficiencies or material weaknesses if they result in a large enough impact on the financial statements.

Control deficiencies are considered consequential if they would result in "more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected."When a significant deficiency causes a material misstatement, as defined again by the 5% rule, it becomes a material weakness.

The working materiality ranges for both uncorrected/unrecorded misstatements and for control deficiencies thus range from inconsequential to consequential to material misstatements. However, the actual materiality levels for the ranges are different. What is material and considered a material misstatement or material weakness based on the 5% rule calculation is, of course, the same.

Uncorrected/unrecorded misstatements generally are related to control deficiencies. Whenever such a misstatement exists, auditors must ask whether the actual euro misstatement is the result of a control deficiency. However, the amount of the uncorrected/unrecorded misstatement is not necessarily the amount of the deficiency. For example, a trader may fail to record a trade and the error may go unnoticed for several reporting periods. While the amount of the uncorrected/unrecorded misstatement is exactly the amount of the unrecorded trade, the control deficiency is based on the euro volume of trades that could have gone unrecorded before such an error was found, based on the mitigating controls that eventually would have discovered and prevented such mistakes. This emphasizes the importance of designing adequate mitigating controls in a company's overall internal control plan. Any time a key control fails, management must have effective mitigating controls that will prevent the resulting potential financial statement error from becoming material.

The materiality of the control deficiency must be determined based on the potential financial statement misstatement that could have occurred, regardless of whether one actually happened and irrespective of the dollar error of any actual financial statement mistake.

Quantitative factors play a large role in determining the potential misstatement that could have resulted from an existing control deficiency. For example, an employee may have committed a fraud by overriding an internal control and stealing an actual euro amount. This amount would be the uncorrected/unrecorded misstatement. However, the control deficiency amount is based on how much could have been stolen because of the internal control weaknesses weighted by the likelihood of someone stealing this amount.

EXCEPTION 3 - ACCOUNTING ESTIMATES: The third perspective on working materiality levels concerns variances from original estimates. Because estimation processes are evaluated based on their adequacy, an accounting estimation generally would not result in a control deficiency or an uncorrected/unrecorded misstatement if it were reasonable given:

1. *The available technology.*
2. *The process was "normal" for the industry.*
3. *The company's independent auditor reviewed and approved it.*

Estimating financial events and balances is a necessary evil, given management's need to report on the income and state of assets at artificial points in time. As long as the estimation process is reasonable, auditors cannot conclude a control deficiency exists when the actual amount is compared with the estimate, regardless of how large the variance given that a better estimate was not possible.

If the estimation process is flawed, broken or unreasonable, a control deficiency exists. An uncorrected/unrecorded misstatement also may exist—the difference between the estimated, calculated and recorded in error vs. what the correct estimate should have been.

EXCEPTION 4 - FRAUD: The fourth perspective on working materiality is financial fraud, performed for the company by management or employees who intended to materially misrepresent the entity's financial position and results of operations. How much of a misrepresentation is required to be material? The answer is twofold.

Fraud generally is not limited by amount but rather by intent. In other words, if the intent was to defraud someone by 1 euro or by 1 million Euros it's still fraud. It's not the amount that makes it fraud. As Staff Accounting Bulletin no. 99 explains, a material misrepresentation is not tied to the amount of the misrepresentation but rather occurs whenever there was intent to misrepresent the registrant's financial position and results of operations and such a misrepresentation occurred. Therefore, if somebody makes a 10,000 Euros entry giving a company the one cent it needs to meet its earnings target and the entry was not based on Generally Accepted Accounting Principles but rather on management's need to meet this target, the entry was a material misrepresentation. This explains why management's intent always should be to fairly present in all material respects the results of operations and condition of assets when recording any accounting entries into the company's books and records.

A fraud on the part of an employee(s) or management that is against the company follows the normal uncorrected/unrecorded misstatements and control deficiency materiality rules and levels. For example, any fraud where employees attempt to help the company by artificially enhancing earnings for financial position would be a fraud for the company. On the other hand a fraud where someone attempts to harm the company by misusing or misappropriating its assets for their own benefit would be against the company.

MINIMIZING EXCEPTIONS: Auditors must understand each of the four perspectives of materiality, to be able to estimate the effect of key control exceptions on companies' fair presentation of its financial statements. But it's equally important to develop an ongoing key control risk reporting process that ensures the timely identification of these issues. The right processes will minimize key control exceptions and meet every accountant's goal of providing fair and complete financial information.

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