

Practical Guidance No. 3

Topic: Materiality for Audit of Separate Financial Statements of Small Companies

Introduction

1. In designing the audit plan, Singapore Standard on Auditing (“SSA”) 320 “Audit Materiality” provides that an auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements and to evaluate whether the financial statements are prepared, in all material respects, in accordance with applicable Financial Reporting Standards (Paragraphs 4 and 5).
2. This Practical Guidance aims to provide some practical considerations to auditors when establishing materiality during the planning phase of an audit.

Guiding Principle

3. SSA 320 establishes that “The auditor should consider materiality and its relationship with audit risk when conducting an audit” (Paragraph 2).
4. SSA 320 also states that “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” (Paragraph 3).
5. SSA 320, however, does not provide any guidance on the establishment of materiality but merely states that “the assessment of what is material is a matter of professional judgement” (Paragraph 4) and materiality “should be considered by the auditor when determining the nature, timing and extent of audit procedures and evaluating the effect of misstatements” (Paragraph 8).
6. The Revised SSA 320 “Materiality in Planning and Performing an Audit”, which is effective for audits of financial statements for periods beginning on or after 15 December 2009, provides some considerations specific to small entities as well as guidance on the use of benchmarks in determining materiality for financial statements as a whole. Specifically, it discusses the factors to consider in selecting an appropriate benchmark and gives examples of different benchmarks that could be used such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

7. In addition, the Revised SSA 320 requires the auditor to determine materiality for the financial statements as a whole when establishing the overall audit strategy and determining the performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures (paragraphs 10 and 11). Performance materiality is set to reduce to an appropriately low level, the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level, the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The performance materiality will determine the nature, timing and extent of audit procedures to be performed.

Practical Application

8. Section 7.4 of the ICPAS Audit Manual for Small Companies provides guidance to auditors on the determination of materiality as follows:

S\$	<i>Profit before taxation parameter</i>	<i>Turnover parameter and total assets parameter</i>
Up to S\$5m	10%	3.0%
S\$5m to S\$6.5m		2.5%
S\$6.5m to S\$8m		2.0%
S\$8m to S\$10m		1.5%
Over S\$10m		1.0%

The auditor would need to assess which of the above parameters is the most appropriate parameter to use to calculate materiality, considering factors such as the audit risk or engagement risk involved, history of noted audit differences in the past financial years, nature of the business, the auditor’s evaluation of the company’s internal controls etc. The materiality established should not be an arithmetic average of the materiality computed based on each parameter. In general, the level of materiality

is relative to the size of the business. Although profit before taxation is usually used to compute materiality, there may be circumstances where it is not an appropriate parameter for example, when the company is at or near the break-even point or incurring losses. The auditor may then wish to consider the use of revenue since it would be indicative of the level of business and transactions. For asset based businesses, the auditor should consider using the asset base to compute materiality.

9. When using profit before tax to compute materiality, the auditor should add back or deduct exceptional items not in the ordinary course of business if these are included in the determination of profit before tax. Examples of such exceptional items include waiver of loans from directors, gain or loss on disposal of an investment property when the core business of the company is not that of the buying and selling of investment properties, discretionary bonuses paid to directors, etc.
10. There may be circumstances where other parameters may be appropriate for the purpose of establishing materiality. For a “cost-plus” company where its principal revenue is determined based on an agreed-upon percentage mark-up of expenses incurred on behalf of a related corporation, the total of such expenses incurred on behalf may be used as a parameter to compute materiality. The percentage to be applied to this parameter is a matter of professional judgement.
11. The auditor should also consider the materiality established in the prior year as well as the individual balances on the balance sheet and profit and loss account to have an indication of whether the materiality set for the current year is too high or too low.
12. The determination of materiality is a matter of professional judgement. Generally, the materiality established corresponds to the size of the business of the company. In all circumstances, the basis for setting materiality should be adequately documented in the working papers as required under paragraph 2 of SSA 230 “Audit Documentation” which state that the auditor should “prepare, on a timely basis, audit documentation that provides a sufficient and appropriate record of the basis for the auditor’s report”.

Revision on materiality as the audit progresses

13. The auditor should evaluate whether the judgement about materiality remains appropriate as the audit progresses as stated in paragraph 4 of SSA 315 “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement”. During the course of the audit, the auditor should review the materiality established during the planning phase to determine if the preliminary materiality remains appropriate. Changes in circumstances or change in the auditor’s knowledge as a result of performing audit procedures could result in a change in audit risk as stated in paragraph 11 of SSA 320. If the preliminary materiality set is too high, the auditor needs

to consider if additional audit procedures are required to reduce the audit risk to an acceptably low level.

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