

NSA 06

NEPAL STANDARDS ON AUDITING AUDIT MATERIALITY

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Introduction

1. The purpose of this Nepal Standard on Auditing (NSA) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.
2. This NSA is to be read in conjunction with the Preface to Nepal Standards on Auditing.
3. This NSA contains the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material.
4. This NSA needs only be applied to material matters.
5. **The auditor should consider materiality and its relationship with audit risk when conducting an audit.**
6. "Materiality" is defined in the Nepal Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

"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."

Materiality

7. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.** The assessment of what is material is a matter of professional judgement.

8. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.
9. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.
10. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered.
- 11. Materiality should be considered by the auditor when:**
 - (a) determining the nature, timing and extent of audit procedures; and**
 - (b) evaluating the effect of misstatements.**

The Relationship between Materiality and Audit Risk

12. When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.
13. There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:
 - (a) reducing the assessed level of control risk, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or

- (b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and Audit Risk in Evaluating Audit Evidence

- 14. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditor's knowledge as a result of the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the Effect of Misstatements

- 15. **In evaluating the fair presentation of the financial statements the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.**
- 16. The aggregate of uncorrected misstatements comprises:
 - (a) specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and
 - (b) the auditor's best estimate of other misstatements which cannot be specifically identified (i.e., projected errors).
- 17. When the auditor tests an account balance or class of transactions by an analytical procedure, he ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatements might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that misstatements might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the aggregate misstatement in the balance or class.
- 18. When the auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in the sample to the items in the balance or class from which the sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

19. The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.
20. **If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report on financial statements.**
21. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing the risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

Compliance with International Standards on Auditing

22. Compliance with this NSA ensures compliance in all material respects with ISA 320 (Audit Materiality).

Effective Date

23. This Nepal Standard on Auditing becomes operative for the audit commencing on or after 01 Shrawan 2061 corresponding to 16 July 2004. Earlier application is encouraged.

Public Sector Perspective

In assessing materiality, the public sector auditor must, in addition to exercising professional judgement, consider any legislation or regulation which may impact that assessment. In the public sector, materiality is also based on the “context and nature” of an item and includes, for example, sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern or public interest.