**2.0. Audit risk and materiality**

The scope paragraph in an audit report includes two important phrases (italicized below) that are directly related to materiality and risk.

‘We conducted our audits in accordance with auditing standards. Those standards require that we plan and perform the audit to *obtain reasonable assurance* about whether the financial statements are *free of material misstatement’*.

The phrase *obtain reasonable assurance* is intended to inform users that auditors do not guarantee or ensure the fair presentation of the financial statements. Some risk that the financial statements are not fairly stated exists, even when the opinion is unqualified.

The phrase *free of material misstatement* is intended to inform users that the auditor’s responsibility is limited to material financial information. Materiality is important because it is impractical for auditors to provide assurances on immaterial amounts.

Materiality and risk are fundamental to planning the audit and designing an audit approach. In this chapter, we will show how these concepts fit into the planning phase of the audit.

**2.1. Audit risk**

Audit risk can be defined as the risk that financial statements may contain a material error that may go undetected during the course of the audit. Audit risk is also used sometimes to describe the level or risk that the auditor is prepared to accept during an audit engagement. The auditor may set a target level of risk and adjust the amount of detailed audit work to minimize the overall audit risk.

Audit risk can be categorized as:

**2.1.1. Inherent risk**

The risk that an error exists that could be material or significant when combined with other errors encountered during the audit, assuming that there are no related compensating controls. Inherent risk can also be categorized as the susceptibility to a material misstatement in the absence of related controls. For example, complex calculations are more likely to be misstated than simple ones and cash is more likely to be stolen than inventory of coal or maize. Inherent risks exist independent of an aud it and can occur because of the nature of the business. Thus nature of client business, results of prior audits, whether the engagement is initial or repeat, and the existence of related parties all affect inherent risk.

**2.1.2. Control risk**

This is the risk that a material error exists that will not be prevented or detected in a timely manner by the internal controls system. For example, preparation of daily cash lists for sales may fail to detect unrecorded sales transactions.

**2.1.3. Detection risk**

The risk that an auditor uses an inadequate test procedure and concludes that material errors do not exist when, in fact, they do. Detection of an error would not be determined during the risk assessment phase of an audit. However, in identifying detection risk we evaluate and assess the auditor's ability to test, identify and recommend the correction of material errors as the result of a test.

**2.1.4. Overall audit risk**

The combination of the individual categories of audit risks assessed for each specific control objective. An objective in formulating the audit approach is to limit the audit risk in the area under scrutiny so the overall aud it risk is at a sufficiently low level

From the perspective of the auditor, we also have **engagement risk**- the risk that the auditor or audit firm will suffer harm (e.g. arising from law suits) after the audit is finished, even though the audit report was correct. Engagement risk is closely related to client business risk. In assessing acceptable overall audit risk, an auditor will consider the extent to which external users rely on the audit report. The greater the number of users the lower the acceptable risk. The number of users relying on the report may be affected by factors such as the size of the business, distribution of ownership (public vs. private), and the nature and amount of liabilities. The auditors’ evaluation of management integrity is also an important determinant of acceptable audit risk, as is the probability of the business having problems after the audit (indicated by liquidity position, leverage, e.t.c.).

**2.2. Materiality**

The word "material," when associated with any of these components of risks, refers to an error that should be considered significant to any party concerned with the item in question. Materiality considerations combined with an understanding of audit risk are essential concepts for planning areas to be audited as well as the specific tests to be performed in a given audit. The assessment of what is material is a matter of professional judgment and includes consideration of the effect on the organization as a whole, and errors, omissions, irregularities and illegal f acts that may arise as a result of control weaknesses in the area being audited.

The FASB defines materiality as the magnitude of an omission or misstatement of accounting information that, in 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.

Specifically this 'means that an internal control weakness or set of combined internal control weaknesses leaves the organization highly susceptible to the occurrence of a threat (e.g., financial 'loss, business interruption, loss of customer trust, economic sanction, etc.). The auditor should be concerned with assessing the materiality of the items in question through a risk-based audit approach to evaluating intern al controls.

Similarly, when evaluating internal controls, the auditor should realize that a given system may not detect a minor error. However, that specific error, combined with others, could become material to the overall system. The concept of materiality requires sound judgment from the auditor. The auditor may detect a small error that could be considered significant at an operational level, but may not be viewed as significant to upper management. Materiality considerations combined with an understanding of audit risk are essential concepts for planning the areas to be audited and the specific test to be performed in a given audit.

Several factors affect the auditor’s preliminary judgment about materiality for a given set of financial statements. The most important of these are:

Materiality Is a Relative Rather Than an Absolute Concept

A misstatement of a given magnitude might be material for a small company, whereas the same misstatement could be immaterial for a large one.

Bases Are Needed for Evaluating Materiality

Because materiality is relative, it is necessary to have bases for establishing whether misstatements are material. *Net income* *before taxes* is often the primary base for deciding what material for profit-oriented businesses is because it is regarded as a critical item of information for users. Some firms use a different primary base, because net income often fluctuates considerably from year to year and therefore does not provide a stable base, or when the entity is a not-for profit organization. Other primary bases include net sales, gross profit, and total or net assets. After establishing a primary base, auditors should also decide whether the misstatements could materially affect the reasonableness of other bases such as current assets, total assets, current liabilities, and owners’ equity. Auditing standards require the auditor to document in the audit files the basis used to determine the preliminary judgment about materiality.

Qualitative Factors Also Affect Materiality

Certain types of misstatements are likely to be more important to users than others, even if the amounts are the same. For example:

• Amounts involving fraud are usually considered more important than unintentional errors of equal amounts because fraud reflects on the honesty and reliability of the management or other personnel involved. For example, most users consider an intentional misstatement of inventory more important than clerical errors in inventory of the same amount.

• Misstatements that are otherwise minor may be material if there are possible consequences arising from contractual obligations. Say that net working capital included in the financial statements is only a few hundred shillings more than the required minimum in a loan agreement. If the correct net working capital were less than the required minimum, putting the loan in default, the current and noncurrent liability classifications would be materially affected.

• Misstatements that are otherwise immaterial may be material if they affect a trend in earnings. For example, if reported income has increased 3 percent annually for the past 5 years but income for the current year has declined 1 percent, that change may be material. Similarly, a misstatement that would cause a loss to be reported as a profit may be of concern. Accounting and auditing standards do not provide specific materiality guidelines to practitioners.

Materiality Guidelines

Most public accounting firms provide guidance to their staff auditors to promote consistent materiality judgments. The guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pre-tax income. In choosing a base, the auditor considers the stability of the base from year to year, so that overall materiality does not fluctuate significantly between annual audits. Income is often more volatile than total assets or revenue.

A simple guideline for small business audits could be, for example, to set overall materiality at 1% of total assets or revenue, whichever is higher. A traditional starting point for many companies is 5% of net income. The percentage may be smaller for large clients. Some CPA firms have more complicated guidance that may be based on the nature of the industry or a composite of materiality decisions made by experts in the firm. But any guidance is just that. The auditor may use the guidance as a starting point that should be adjusted for the qualitative conditions of the particular audit.

Risk assessment

Risk assessments should identify, quantify and prioritize risks against criteria for risk acceptance and objectives' relevant to the organization. The results should guide and determine the appropriate management action, priorities for managing risks and priorities for implementing controls selected to protect against these risks.

Risk assessment should include the systematic approach of estimating the magnitude of risks (risk analysis) and the process of comparing the estimated risks against risk criteria to determine the significance .of the risk (risk evaluation). Risk assessments should also be performed periodically to address changes in the environment and the risk situation (e.g. in the assets, threats, vulnerabilities, impacts), and when significant changes occur.

There are many risk assessment methodologies, computerized and non computerized from which the auditor may choose. These range from simple classifications of high, medium and low, based on the auditors judgement, to complex scientific calculations to provide a numeric risk rating.

Risk based audits

The simplest way to think about risk-based audit conceptually is to audit the things that really matter to an organisation. Which are the issues that really matter? Probably those areas that pose the greatest risks. What else would you really want to review? If an organisation has already identified its key risks then you already have the basis for risk based auditing. Clearly, if risks have not been formally identified and assessed then there is a real opportunity for you to work with management to help create this information.

The essence of risk-based audit is therefore customer-focused, starting with the objectives of the activity being audited, then moving on to the threats (or risks) to achievement of those goals and then to the procedures and processes to mitigate the risks. Risk-based audit is therefore an evolution rather than a revolution, although the results obtained can be revolutionary in their magnitude.

More organizations are moving to a risk-based audit approach that is usually adapted to develop and improve the continuous audit process. This approach is used to assess risk and to assist an auditor in making the decision to perform either compliance testing or substantive testing. It is important to stress that the risk based audit approach efficiently assists the auditor in determining the nature and extent of testing.

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