



## The normative acceptability of SAAS 320 – Audit Materiality

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**The process by which an organisation's financial statements are audited by external auditors can be described as a risk-based, systematic approach in which the nature, extent and timing of the audit procedures and audit evidence required, are determined by assessing and evaluating the risk that the financial statement assertions are materiality misstated. In fact, when the external auditor issues a standard unqualified audit report on the financial statements, he/she is confirming, with a high degree of assurance based on persuasive evidence gathered during the audit, that the financial statements are free of *material* misrepresentations, taking cognisance of the fact that the financial statements are presented in accordance with a specified set(s) of criteria.**

**T**he following definition of *audit materiality* applies: An item (representation, fact or amount) included in the financial statements will be material if that item, based on its size or nature, will probably influence the decisions or actions of a reasonable user of the financial statements.

Notwithstanding the obvious importance of *audit materiality* and, in particular, audit materiality judgements that need to be made throughout the audit process and that will ultimately influence auditor/shareholder communication, professional standards worldwide, including SAAS 320 (the relevant South African Auditing Standard), tend to suffice with the following primary guideline: *Determining what is material and what is not is primarily a matter of professional judgement.* Using professional judgement as the principal determinant of audit materiality has serious disadvantages, such as:

- a lack of comparability and diverse results in similar circumstances;
- bias towards the auditor's own data needs and personal perspective, thereby widening the audit expectation gap;
- overestimating the unknown user's knowledge of a particular situation;
- a loss of public confidence in the external audit because of the subjective justification of judgement processes;
- undermining the status of the auditor and the value of auditing services to the users of financial statements;
- reducing the auditor's accountability and obscuring his/her duties and functions.

A possible reason for this undesirable situation is the fact that auditing standards, including SAAS 320, are to a large extent the results of a standard-setting process perceived by many to be defective. Considering auditing a principle of social, political and

economic organisation, focuses the issues around the standard-setting process on the public interest. The auditing standard-setting process is one of the instruments used in the self-regulation of the auditing profession – an instrument various authors have argued is being misused by the standard-setting bodies to exclude certain roleplayers in the accountability framework and thereby furthering agendas reflecting the rationality of certain groupings.

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One strategy used to establish and maintain an exclusive standard-setting approach is the advancement of uncertain professional knowledge by, amongst other things, overemphasizing and elevating the exercise of *professional judgement* to the status of predominate principle in deciding technical and practical accounting and auditing issues. The principle of *professional judgement*, however, poses a problem for auditors who daily have to deal with real practical situations.

Concrete, normatively based guidelines regarding the determination of materiality during an external audit of financial statements are available to assist the auditor. A normative analysis of the relevant auditing theory, in addition to the principles identified from previous materiality studies, enables the identification and formulation of specific normative principles that should apply when determining audit materiality – a total of 26 normative principles can be identified in this way. But are these included in the relevant auditing standards?

The auditing standard-setting process in South Africa has produced SAAS 320 with regard to audit materiality. SAAS 320 contains the following principles or standards pertaining to the *determination* of audit materiality for purposes of providing guid-

ance to auditors on the concept of materiality (note, principles in respect of the *application* of audit materiality are not dealt with here):

- a Materiality needs to be considered in determining the nature, timing and extent of auditing procedures (planning and designing) and in evaluating the results of those procedures.
- b Materiality judgements involve both quantitative and qualitative considerations.
- c The consideration of materiality by the auditor is a matter of professional judgement.
- d Materiality is considered at both the overall financial statements level and in relation to individual account balances/items. This can result in different materiality levels depending on the aspect being considered.
- e The audit is primarily planned to detect errors (quantitative items) that could be material to the financial statements taken as a whole, either individually or in aggregate.
- f There is an inverse relationship between audit risk and materiality. The components of audit risk and the inverse relationship with materiality should be considered during the planning of the audit.
- g The planning materiality figure will normally be lower than the final materiality figure, because of considerations in respect of the inherent limitations of the audit process – this provides a margin of safety.
- h The auditor's consideration of final materiality and planning materiality will probably differ, because when planning the audit it is difficult to anticipate all of the circumstances that will ultimately influence the auditor's judgement about materiality in evaluating audit findings at the completion phase.
- i When determining whether errors or irregularities are material or not, the auditor should consider their amount (quantitative materiality) and nature (qualitative materiality) in relation to the items in the financial statements under examination.
- j When determining whether errors or irregularities are material or not, their (quantitative) effect on the financial statements taken as a whole should be consid-

ered individually and in the aggregate.

- k When aggregated uncorrected misstatements approach the materiality level there is an increased risk that together with undetected misstatements, the materiality level may be exceeded. This risk should be reduced by performing additional audit procedures or requesting adjustments by management.

When comparing the above standards to available normative principles, the following observations apply:

- Of the 26 available normative principles referred to earlier, only eight are addressed by the professional standards above. Five professional standards correspond in essence with the concomitant normative principles and three normative principles are, to a greater or lesser extent, implied by the professional standards.
- Professional standard c, in context, suggests that the exercise of professional judgement is the predominate factor which influences the determination of audit materiality. While the related normative principle acknowledges that professional judgement will always play an important role in the decision process, the other normative principles provide *concrete guidelines* that provide a framework within which professional judgement should be exercised – something that the standards contained in SAAS 320 do not do.
- Professional standard f describes the relationship between audit materiality and audit risk in principle, but fails to explain how this relationship will be applied during the actual determination of audit materiality.
- The fact that some normative principles are only *implied* by the professional standards – the professional standards do not clearly and decisively mention the particular normative principles – is alarming. Recognising the implication of the relevant normative principles and judging the standards in proper context require a clear understanding and insight into the normative principles and the underlying theory. The average practising auditor would probably have difficulty in identifying the connection, not to mention other less informed readers of the pronouncements concerned. In short, the profession-

al standards lack content and are not clear and precise to the extent possible.

- Normatively it is possible to identify specific quantitative and qualitative factors which influence materiality decisions, and therefore represent available factors for consideration in a particular audit situation. SAAS 320, however, provides no such guidance.
- With regard to the 18 normative principles that are not included in SAAS 320, cognisance should be taken of their underlying nature. Ten of these normative principles discuss the distinction between quantitative and qualitative materiality in detail, including describing how quantitative and qualitative materiality should be determined with regard to certain decision items. The other eight normative principles provide specific guidance on how to determine audit materiality, both quantitatively and qualitatively – five principles relate to the calculation of the materiality limit, while three relate to the consideration of qualitative factors.

The above observations indicate that the materiality standards contained in SAAS 320 are normatively based, but that some of the standards are not clear and precise to the extent permitted by the related normative principles. The problem, however, is that SAAS 320 does not include approximately 69% of the available normative principles (as referred to earlier) applicable to the determination of audit materiality. This supports a conclusion that in respect of determining audit materiality, the auditing standards concerned suggest the preference of standard-setting bodies not to provide concrete guidelines to the extent it is possible. To this extent it is proposed that SAAS 320 is not normatively acceptable.

Two major shortcomings are prevalent, namely: overemphasising the exercise of professional judgement, while concrete, normatively based guidelines are available and desirable, and providing for various alternatives, while normative principles favour a specific approach.

Is it, therefore, unreasonable to deduce that SAAS 320 is yet another example of how the auditing standard-setting process is being misused to further so-called uncertain professional knowledge?

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