Chapter 8 – Materiality Decisions and Performing Analytical Procedures
Chapter 8 Overview

Materiality Decisions and Performing Analytical Procedures

Materiality Decisions
- The Concept of Materiality
- Preliminary Judgments About Materiality
- Materiality and the Evaluation of Evidence

Performing Analytical Procedures
- Identify Calculations and Comparisons to Be Made
- Develop an Expectation Range
- Perform the Calculations
- Analyze Data and Identify Significant Differences
- Investigate Significant Unexpected Differences
- Determine Effects on Audit Planning
- Illustrative Case Study
Concept of Materiality

• Auditor Considerations
  – Circumstances pertaining to the entity
  – Information needs of those relying on financial statements

• Purposes for Preliminary Judgments
  – Scope decisions
  – Evaluation of known misstatements
Preliminary Judgments About Materiality

• Planning Materiality
  – Circumstances change
  – Additional information identified

• Judgments at Two Levels
  – Financial Statement Level
  – Account Balance Level
Materiality at the Financial Statement Level

• Quantitative Guidelines
  – No official guidelines within auditing standards
  – 5-10% of Net Income before Taxes
  – $\frac{1}{2}$-$1\%$ of Total Assets

• Qualitative Considerations
  – Quantitatively immaterial, qualitatively material
  – Illegal act by entity
Materiality – Quantitative Example

Figure 8-1  Materiality Levels Based on a Variable Percentage of Total Assets or Revenues

<table>
<thead>
<tr>
<th>If the Greater of Total Assets or Revenues is</th>
<th>But Not Over</th>
<th>Materiality Is</th>
<th>Of the Excess Over</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 0</td>
<td>$ 30 thousand</td>
<td>$ 0 + .059</td>
<td>$ 0</td>
</tr>
<tr>
<td>30 thousand</td>
<td>100 thousand</td>
<td>1,780 + .031</td>
<td>30 thousand</td>
</tr>
<tr>
<td>100 thousand</td>
<td>300 thousand</td>
<td>3,970 + .0214</td>
<td>100 thousand</td>
</tr>
<tr>
<td>300 thousand</td>
<td>1 million</td>
<td>8,300 + .0145</td>
<td>300 thousand</td>
</tr>
<tr>
<td>1 million</td>
<td>3 million</td>
<td>18,400 + .0100</td>
<td>1 million</td>
</tr>
<tr>
<td>3 million</td>
<td>10 million</td>
<td>38,300 + .0067</td>
<td>3 million</td>
</tr>
<tr>
<td>10 million</td>
<td>30 million</td>
<td>85,500 + .0046</td>
<td>10 million</td>
</tr>
<tr>
<td>30 million</td>
<td>100 million</td>
<td>178,000 + .00313</td>
<td>30 million</td>
</tr>
<tr>
<td>100 million</td>
<td>300 million</td>
<td>397,000 + .00214</td>
<td>100 million</td>
</tr>
<tr>
<td>300 million</td>
<td>1 billion</td>
<td>856,000 + .00145</td>
<td>300 million</td>
</tr>
<tr>
<td>1 billion</td>
<td>3 billion</td>
<td>1,840,000 + .00100</td>
<td>1 billion</td>
</tr>
<tr>
<td>3 billion</td>
<td>10 billion</td>
<td>3,830,000 + .00067</td>
<td>3 billion</td>
</tr>
<tr>
<td>10 billion</td>
<td>30 billion</td>
<td>8,550,000 + .00046</td>
<td>10 billion</td>
</tr>
<tr>
<td>30 billion</td>
<td>100 billion</td>
<td>17,800,000 + .00031</td>
<td>30 billion</td>
</tr>
<tr>
<td>100 billion</td>
<td>300 billion</td>
<td>39,700,000 + .00021</td>
<td>100 billion</td>
</tr>
<tr>
<td>300 billion</td>
<td>—</td>
<td>82,600,000 + .00015</td>
<td>300 billion</td>
</tr>
</tbody>
</table>
Materiality at the Account Balance Level

• Account Balance Materiality

• Tolerable Misstatement

• Material Account Balance
Allocating Financial Statement Materiality to Accounts

• When financial statement materiality is quantified

• Must allocate to individual accounts

• Balance Sheet and Income Statement accounts

• Two Considerations
  – Material misstatement amount of account
  – Probable cost of verification
Materiality and Audit Evidence

• Sufficiency of Evidence
  – Inverse relationship
  – Lower amount of tolerable misstatement needs more evidence to obtain reasonable assurance

• Evaluation of Evidence
  – Reevaluate preliminary materiality
  – Quantitative and Qualitative considerations
1. In making preliminary judgments about materiality, the auditor should assess materiality at ______ levels.

A. One  
B. Two  
C. Three  
D. Four

B. Two
2. Any amount of misstatement that is less than the level of materiality would be referred to as:

A. Quantitative misstatement
B. Material misstatement
C. Tolerable misstatement
D. Probable misstatement

C. Tolerable misstatement
3. Materiality and audit evidence are said to have a(n) _______ relationship.

A. Inverse
B. Converse
C. Obtuse
D. Correlating

A. Inverse
Performing Analytical Procedures

Figure 8-4  ■ Steps Involved in Performing Analytical Procedures

1. Identify calculations and comparisons to be made
2. Develop an expectation range
3. Perform the calculations (using the entity’s data)
4. Analyze data and identify significant deficiencies
5. Investigate significant unexpected differences
6. Determine effects on audit planning
Identify Calculations and Comparisons to be Made

• Absolute Data Comparisons

• Common-size Financial Statements

• Ratio Analysis

• Trend Analysis

• Compare Financial Information with Nonfinancial Information
# Effectiveness of Analytical Procedures

## Figure 8-5  ■ Factors that Influence the Effectiveness of Analytical Procedures

<table>
<thead>
<tr>
<th>Less Effective</th>
<th>Key Factors</th>
<th>More Effective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analytical procedures may or may not specifically relate to the assertion.</td>
<td>Nature of the assertion</td>
<td>Analytical procedures specifically relate to the assertion.</td>
</tr>
<tr>
<td>Data that may not be related to each other may lead to erroneous conclusions.</td>
<td>Plausibility and predictability of relationship</td>
<td>Data that is related to each other will lead to more reliable conclusions.</td>
</tr>
<tr>
<td>Relationship that are dynamic or unstable are less predictable.</td>
<td>Availability of reliable Data</td>
<td>Relationships that are stable are also more predictable.</td>
</tr>
<tr>
<td>Data used is from sources inside the entity.</td>
<td>Precision of the expectation</td>
<td>Data used is from independent sources outside the entity.</td>
</tr>
<tr>
<td>Data was not developed under a reliable system of internal controls.</td>
<td></td>
<td>Data was developed under a reliable system of internal controls.</td>
</tr>
<tr>
<td>The data has not been subjected to audit testing in the current or prior years.</td>
<td></td>
<td>The data has been subjected to audit testing in the current or prior years.</td>
</tr>
<tr>
<td>Expectations are developed using data from a single source.</td>
<td></td>
<td>Expectations are developed using data from a variety of sources.</td>
</tr>
<tr>
<td>Imprecise models lead to a wider range of expectations.</td>
<td></td>
<td>Precise models lead to a narrower range of expectations.</td>
</tr>
<tr>
<td>Imprecise models have multiple factors that affect the data being audited, and it is difficult to distinguish the factors that influence the outcome.</td>
<td></td>
<td>Precise models identify the factors that affect the data being audited.</td>
</tr>
</tbody>
</table>
Develop an Expectation Range

• Comparable Prior Periods

• Formal Budgets and Forecasts

• Relationships of Financial Statement Elements

• Industry Data
Performing Analytical Procedures

• Perform the Calculations

• Analyze Data and Identify Significant Differences

• Investigate Significant Unexpected Differences

• Determine Effects on Audit Planning
4. This technique, often referred to as a vertical analysis, involves calculating the percentage of a related total and then comparing to expected amounts.

A. Ratio Analysis
B. Trend Analysis
C. Absolute Data Comparisons
D. Common-size Financial Statements

D. Common-size Financial Statements
5. In developing an expectation range, an auditor should use all of the following, except:

A. Comparable prior periods
B. Formal budgets and forecasts
C. Industry data
D. All of the above should be used

D. All of the above should be used