CONCEPT PAPER ON "MATERIAL" & "MATERIALITY"

(Approved by the CASB in its 96th meeting held on 14th August 2020)

In English dictionary, the term **"Material"** when used as an adjective means 'important or having an important effect'. Its similar words are significant, major, important, consequential, momentous, weighty, vital, essential, key, meaningful, etc. and the opposite words used are unimportant, insignificant, inconsequential, etc.

Material means of sufficient importance or relevance as to have possible significant influence on an outcome.

Materiality in Accounting

In **accounting**, materiality refers to the relative size of an amount. Relatively large amounts are **material**, while relatively small amounts are not **material** (or immaterial). Determining materiality requires professional judgement.

The International Accounting Standards Board (IASB) framework, *Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.* Accordingly, the earlier definition of materiality as per IAS 1 was:

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements."

On 31 October 2018, the IASB amended the definition of materiality in IFRS Standards by amending IAS 1 and IAS 8. The amended definition of materiality, as given below, is effective from 1 January 2020.

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."

Materiality therefore relates to the significance of transactions, balances and errors contained in the financial statements. Materiality defines the threshold or cutoff point after which financial information becomes relevant to the decision making needs of the users. Information contained in the financial statements must therefore be complete in all material respects in order for them to present a true and fair view of the affairs of the entity.

Materiality is relative to the size and particular circumstances of individual companies. *Example of size* – a default by a customer who owes only Rs.100 to a company having turnover worth Rs.100 crore is immaterial to the financial statements of the company. However, if the amount of default is Rs.2 crore, the information would be material & its omission can cause users to make incorrect business decisions. *Example by nature* – if a company is planning to curtail its operations in a geographic segment which has traditionally been a major source of revenue for the company in the past, then this information should be disclosed in the financial statements as it is by its nature material to understanding the entity's scope of operations in the future.

Materiality is further linked to the following accounting concepts and principles:

i) *Relevance*: Material information influences the economic decisions of the users and is therefore relevant to their needs.

ii) *Reliability*: Omission or misstatement of an important piece of information impairs users' ability to make correct decisions taken on the basis of financial statements thereby affecting the reliability of information.

iii) *Completeness*: Information contained in the financial statements must be complete in all material respects in order to present a true and fair view of the affairs of the company.

As defined in the Indian Accounting Standards

Ind AS 1 on 'Presentation of Financial Statements' and Ind AS 8 on 'Accounting Policies, Changes in Accounting Estimates, and Errors' contain identical definition of the term "Material". It is stated as under:

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or

misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

It has been further stated that assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users.

As per the Notification dated 24th July, 2020 issued by the Ministry of Corporate Affairs, Ind AS 1 and Ind AS 8 have been amended and the identical definition of the term "Material" as given in the amended IAS 1 and IAS 8 has been adopted, which is reproduced below:

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."

As defined by the International Public Sector Accounting Standards Board

Material - Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements. Materiality depends on the nature and size of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor.

The aforesaid definition is almost similar to that given by the IASB or appearing in the Indian Accounting Standards (Ind AS).

Materiality in Auditing

The International Auditing and Assurance Standards Board (IAASB) has issued International Standards on Auditing (ISAs).

In terms of ISA 200, the auditor expresses an opinion on whether the financial statements are prepared, in all **material** respects, in accordance with an applicable financial reporting framework, such as IFRS.

ISA 320 on Materiality in Planning and Performing an Audit defined the term "Performance Materiality" as under:

"Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures."

ISA 320 states that this assessment of what is material is a matter of professional judgement. It requires the auditor to set "performance materiality" that is applied to particular transactions, account balances or disclosures. Further, inverse relationship exists between audit risk and materiality. Higher the audit risk, lower the materiality will be set; and lower the audit risk, higher the materiality will be set.

The IASB has refrained from giving quantitative guidance for the mathematical calculation of materiality. ISA 320 does provide for the use of benchmarks to calculate materiality.

Material & Materiality in Cost Accounting Standards and Standards on Cost Auditing issued by the Institute

Cost Accounting Standards or the Glossary of Terms do not define the terms "Material" or "Materiality". However, under the head Presentation, it has been prescribed that costs shall be presented in the cost statement, if material. Similarly, in the Disclosure requirements, it has been stated that disclosures shall be made only where material, significant and quantifiable.

The Institute has already approved & issued SCA-108 Standard on Cost Auditing on "Materiality in Planning and Performing a Cost Audit". The Standard is awaiting government approval. In this Standard, the term "Performance Materiality" has been defined as under:

"Performance Materiality: means materiality level or levels set by the cost auditor for the cost statements as a whole or for particular items of cost, to reduce the audit risk."

Requirements with respect to materiality and performance materiality, together with Application Guidance have been elaborately given in the Standard (copy attached). It explains the concept of materiality in the preparation and presentation of cost statements as under:

a) Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the decisions taken on the basis of the cost statements;

b) Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

c) Judgments about matters that are material to users of the cost statements are based on a consideration of the common cost information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Such a discussion provides a frame of reference to the cost auditor in determining materiality for the cost audit. The cost auditor's determination of materiality is a matter of professional judgment, and is affected by the cost auditor's perception of the cost information needs of users of the cost statements.

Definitions as approved by the CASB

Cost Accounting Standards or the Glossary of Terms do not define the terms "Material" or "Materiality" or "Performance Materiality". However, under the head Presentation, it has been prescribed that costs shall be presented in the cost statement, if material. Similarly, in the Disclosure requirements, it has been stated that disclosures shall be made only where material, significant and quantifiable. Hence the terms "Material", "Materiality", and "Performance Materiality" have been defined as under.

Material - means any cost, value, data or information is material if its omission, concealment or misstatement, individually or in aggregate, could result in distorting the true & fair view of the cost statements and could reasonably be expected to influence the decisions taken on the basis of those cost statements;

Determination of whether any cost, value, data or information is material would depend upon the

a) professional judgement of the preparer of cost statements; and
b) size and particular surrounding circumstances of individual entities.

Materiality – refers to the relative size of amount, or transaction set by the management, accountant or auditor for the purpose of accounting, auditing and reporting so as to reduce the performance risk, audit risk or reporting risk. The materiality level is the value attributed to the client's records below which any errors are acceptably small and would not affect the decisions. Determining materiality requires professional judgement, which is affected by the

a) size or nature of its omission, concealment or misstatement, or a combination of both; and
b) perception of the cost information needs of the users of cost statements.

Performance Materiality – [as defined in SCA-108 Standard on Cost Auditing on "Materiality in Planning and Performing a Cost Audit"] means materiality level or levels set by the cost auditor for the cost statements as a whole or for particular items of cost, to reduce the audit risk. The concept of materiality in the preparation and presentation of cost statements is further explained as under:

a) Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the decisions taken on the basis of the cost statements;

b) Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

c) Judgments about matters that are material to users of the cost statements are based on a consideration of the common cost information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

The performance materiality level or levels set by the cost auditor for the cost statements as a whole or for particular items of cost, to reduce the audit risk, may [or may not] be different from the materiality level adjudged by the preparer of those cost statements.

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