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Qualitative Materiality in Government Audit Planning

By: Sridhar Ramamoorti, Ph.D., ACA, CPA, CFE, CFSA, and Andrea Lee Hoey, MAS, CPA

What is it?
Why is it important?
How can it be used in planning governmental audits?

The answers to the first two questions are presented in a plausible scenario described below. After we demonstrate why qualitative materiality is important, we will proceed to describe several methods for using qualitative materiality more effectively in governmental audit planning.
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The answers to the first two questions are presented in a plausible scenario described below. After we demonstrate why qualitative materiality is important, we will proceed to describe several methods for using qualitative materiality more effectively in governmental audit planning.
The political sensitivity of the area under audit to adverse media exposure and litigation concerns the nature and size of the investigation. The more sensitive the computer system becomes, the less likely it is that evidence will be left behind. The sensitivity of computer systems ranging from national security to individual citizens’ financial histories is an increasing concern. As the size and use of computer systems have increased, so has the sensitivity of computer systems. The forego ing illustration highlights a sort of computer system, an auditor might find evidence of who had access to it. What about national security? If such access was a glitch in the program that caused a computer system, an auditor finds evidence that an unlogged call came from the system. Although the call was subsequently reported on a bill, it was not automatically logged into the computer’s internal log. In the presence of a host of other problems encountered during system implementation, the small dollar amount associated with this inconsistency would make it unlikely to warrant the auditor’s attention. From another perspective, by tracing the source and nature of the call may appear unjustified. But the existence of this unlogged call raises questions about other errors in the computer program? Was there any such access misused? What types of files were accessed by the caller? But then again, it was only $10. How should the amount of time spent evaluating this be determined?

One innocent and harmless outcome could be that the call to the phone was a glitch in the program that caused dial-up access from within the building to not be logged. To be sure, the problem could be remedied easily, but it could be indicative of other widespread deficiencies within the company. Alternatively, the scenario could end on a more sinister note with a computer hacker having accessed sensitive data about national security. If such access to classified information constituted a breach of national security, it would undoubtedly have serious ramifications, including incurring of a significant liability for individuals and settlement costs, in addition to the resulting public embarrassment. The forensic evidence of an “iceberg effect” wherein the small amount that is visible reveals little about the real nature of the problem.
of time spent on un logged calls is a rare exception. The auditor’s expectations in the absence of such a call are unlikely to warrant the auditor’s attention. Further, value judgments in the formulation of materiality factors are not a function of materiality thresholds. The political sensitivity of the area under audit to adverse media exposure and potential embarrassment of the public is a critical issue. Suppose a newly elected, non-career governor decided to move towards a paperless office environment. The decision to eliminate online computer systems. While auditing access to computer files in a newly installed computer system, an auditor finds evidence that an unlogged call came to the system. Although the call was subsequently reported on a bill, it was not automatically logged into the computer’s internal log. In the presence of a host of other problems encountered during system implementation, the small dollar amount associated with this inconsistency would make it unlikely to warrant the auditor’s attention. From an efficiency perspective, tracing the source and nature of the call may appear unjustified. But the existence of this unlogged call may indicate something far qualitatively more serious than other errors in the computer program? Was other such access missed? What other technical or management breaches were there in the computer system?

What types of files were accessed by the caller? But then again, it was only $10. How should the amount of time spent evaluating this be determined? One innocuous and harmless occurrence that may have been missed was a glitch in the program that caused dial-up access from within the building to not be logged. To be sure, this problem could be remedied easily, but it could be indicative of other widespread deficiencies in the system that were not detected. Alternatively, the scenario could end on a more sinister note with a computer hacker having accessed sensitive data about national security. If such access to classified information constituted a breach of national security policies, the access undoubtedly have serious ramifications, including incurring of a significant liability for information theft and potential illegal activities such as illegal acts, bribery and corruption related party transactions, snowballing of unreported losses, etc., all of which grow with time. Qualitative materiality considerations should not be considered as a tool they can and frequently do influence the nature and scope of governmental audits.

Of course, the difficulty lies in achieving consensus among auditors on the relative importance of risk attributes. The political sensitivity of the area under audit to adverse media exposure and litigation concerns the nature and scale of the risk involved and the size of the asset at risk. The sensitivity of computer security becomes a critical issue. Suppose a newly elected governor decided to move towards a paperless office environment. The decision to eliminate online computer systems. While auditing access to computer files in a newly installed computer system, an auditor finds evidence that an unlogged call came to the system. Although the call was subsequently reported on a bill, it was not automatically logged into the computer’s internal log. In the presence of a host of other problems encountered during system implementation, the small dollar amount associated with this inconsistency would make it unlikely to warrant the auditor’s attention. From an efficiency perspective, tracing the source and nature of the call may appear unjustified. But the existence of this unlogged call may indicate something far qualitatively more serious than other errors in the computer program? Was other such access missed? What other technical or management breaches were there in the computer system?

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Guidance from Professional Literature and Standards

Financial Accounting Standards Board (FASB) Concepts Statement No. 2 defines materiality as the magnitude, in terms of size or importance, of misleading information. It is defined as the magnitude, in terms of size or importance, of misleading information. It is a significant exception. The auditor’s expectations in the absence of such a call are unlikely to warrant the auditor’s attention. Further, value judgments in the formulation of materiality factors are not a function of materiality thresholds. The political sensitivity of the area under audit to adverse media exposure and potential embarrassment of the public is a critical issue. Suppose a newly elected, non-career governor decided to move towards a paperless office environment. The decision to eliminate online computer systems. While auditing access to computer files in a newly installed computer system, an auditor finds evidence that an unlogged call came to the system. Although the call was subsequently reported on a bill, it was not automatically logged into the computer’s internal log. In the presence of a host of other problems encountered during system implementation, the small dollar amount associated with this inconsistency would make it unlikely to warrant the auditor’s attention. From an efficiency perspective, tracing the source and nature of the call may appear unjustified. But the existence of this unlogged call may indicate something far qualitatively more serious than other errors in the computer program? Was other such access missed? What other technical or management breaches were there in the computer system?

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of testing to be performed. The application of the conjoint approach is illustrated in Figure 2, which shows that the relatively smaller quantitatively based thresholds of these contracts may warrant the use of the conjoint method.

The auditor would develop an adjustment factor, depending upon his or her judgment and the level of risk on the continuum, which is likely lower in the planning materiality threshold previously determined. The auditor, by lowering the planning materiality thresholds, is automatically increasing the scope and/or extent of testing performed and also increasing the likelihood of finding a pattern of errors or irregularities in avoiding smaller contracts with a cumulatively material effect. In the example outlined in Figure 2, sufficient lowering of the materiality thresholds may improve the chance of identifying medical service contracts that were performed improperly. Some sort of a sliding scale may be employed to achieve proportionate reductions in the overall materiality threshold as the risk ranking goes higher.

Despite the fact that the conjoint method may be effectively a qualitative materiality assessment, it neglects some crucial aspects and may not properly incorporate qualitative aspects in all situations. For example, suppose a proposed law has been recognized. As stated above, the conjoint and disjoint approaches are separate identification and determination of testing determined by the tolerable misstatement or tolerable error. The separate identification and evaluation of qualitative materiality issues has advantages and disadvantages. The main advantage of the conjoint approach is that no adjustments to the current threshold to planning materiality and tolerable material misstatement are necessary. However, a formal means of evaluating qualitative factors must be developed. This may be in the form of an illustrative or concrete language to work papers that identify the qualitative aspects being evaluated or it may be more sophisticated and require identifying a separate audit cycle that requires specialized abilities, such as forensic or investigative auditing. Inherent limitations of the disjoint approach include:

- the possibility that all qualitative material items may not be identifiable (under-auditing);
- the less likelihood for identifying relevant factors (under-auditing); and
- the auditor may unknowingly include inappropriate factors (over-auditing).

On the other hand, specific tests can be designed and tailored to different requirements and the qualitative factors identified can be more completely evaluated. The disjoint approach permits the carrying out of the same audit test with an appropriately reduced planning materiality threshold responsive to a sliding scale computation. Such integration of both qualitative and quantitative aspects in one planning materiality framework may have practical implications. Moreover, using this method may trap "smaller" errors that no longer exist on a qualitative basis. Thus, the impact on the financial statements taken as a whole. However, as noted before, the significant disadvantage of this approach is that the sliding scale computation reinforces the qualitative materiality framework for audit purposes. While the qualitative aspects are largely ignored. Consequently, the conjoint approach may be inappropriate when sufficient lowering of the materiality thresholds fails to occur because the severity of the qualitative materiality issue has not been recognized.

As stated above, the conjoint and disjoint methods differ in terms of the different audit situations. However, the two methods may be used together in certain audits. Deciding which method to incorporate for different situations is a matter of auditor judgment.

The governmental auditing profession could potentially reap significant benefits by adopting a comprehensive materiality framework in practice. Incorporating such a framework not only gives explicit consideration to qualitative aspects in audit procedures but also ensures that governmental auditors are in compliance with SAS No. 47 (AU 812) and the Yellow Book. In addition, the Chief Financial Officers Act of 1990 and other related development seem to indicate that the government entities are to be run more like a business. Careful consideration of issues surrounding governmental financial statements is imperative in helping governments to operate more efficiently and effectively.

**Conclusion**

Government agencies are entrusted with a significant amount of public funds. Therefore, it is important that there exists a well-defined system of accountability to ensure these finances are managed prudently. Government auditors use materiality judgments to determine which of the related systems of accountability are operating effectively. A key component of overall materiality judgments is the consideration of qualitative materiality.

Two alternatives for incorporating qualitative materiality have been identified in this article. The conjoint approach incorporates both quantitative and qualitative materiality and adjusts the qualitative materiality threshold for qualitative factors. The other method, the disjoint approach, considers qualitative and quantitative materiality factors separately in planning governmental audits.

While qualitative aspects have been considered in the past, it is difficult to establish an observable link to the samples chosen and the audit tests performed. However, this difficulty hardly justifies ignoring the unique significance of qualitative materiality in governmental audit planning. Whatever the reasons, it is clear that qualitative materiality as a concept has only been in the periphery of the auditor's vision. Indeed, there is reason to believe that qualitative materiality may not have been adequately considered in audits of government agencies exposed to large losses from derivative transactions, federally insured banks that have become insolvent and one of the most publicized cases of fraud.

Formally recognizing the significance of qualitative materiality in planning governmental audits may provide for more effective audits. It will also generally blunt the public criticism targeted towards government auditors and the quality of their audits.

**References**

American Institute of Certified Public Accountants, "Audit Risk and Materiality in Conducting an Audit," Practice Guide (New York: American Institute of Certified Public Accountants, 1980). In the case of the conjoint approach, both qualitative and quantitative materiality aspects are largely ignored.

The separate identification and evaluation of qualitative materiality issues has advantages and disadvantages. The main advantage of the conjoint approach is that no adjustments to the current threshold to planning materiality and tolerable material misstatement are necessary. However, a formal means of evaluating qualitative factors must be developed. This may be in the form of an illustrative or concrete language to work papers that identify the qualitative aspects being evaluated or it may be more sophisticated and require identifying a separate audit cycle that requires specialized abilities, such as forensic or investigative auditing. Inherent limitations of the disjoint approach include:

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On the other hand, specific tests can be designed and tailored to different requirements and the qualitative factors identified can be more completely evaluated. The disjoint approach permits the carrying out of the same audit test with an appropriately reduced planning materiality threshold responsive to a
of testing to be performed. The application of the conjoint approach is illustrated in Figure 2, which shows that the relatively smaller differences in results for these contracts may warrant the use of the conjoint method.

The auditor would develop an adjustment factor, depending on his or her judgment and the level of risk on the continuum, which would likely lower the quantitative materiality threshold previously determined. The auditor, by lowering the planning materiality thresholds, is automatically increasing the scope and/or extent of testing performed and also increasing the likelihood of finding a pattern of errors or irregularities in avoiding smaller contracts with a cumulatively material effect. In the example outlined in Figure 2, sufficient lowering of the materiality threshold may improve the chance of identifying medical service contracts that were awarded improperly. Some sort of a sliding scale may be employed to achieve proportionate reductions in the overall materiality threshold as the risk ranking goes higher.

Despite the fact that the conjoint method may be effectively used in certain situations, it neglects some crucial aspects and may not properly incorporate qualitative materiality. In the case of being, for example, suppose a proposed law has only an indirect effect on the financial statement. Lowering the materiality will surely increase the extent of testing performed, but may not adequately address the ramifications of the proposed law and the attendant impact on the financial statements. Following the conjoint method may lead to a false sense of assurance since circumstances may have the undesirable outcome of an inefficient and ineffective audit. The auditor should plan to test specifically to address the qualitative factors to limit the risk of material misstatement due to one or more qualitative factors. As explained more fully below, the need for separate testing makes the disjoint approach preferable in certain circumstances.

The Disjoint Approach

In the disjoint approach, both aspects of materiality, quantitative and qualitative, are considered separately during audit planning and performed during the audit. Under this alternative, the assessed quantitative materiality threshold is not adjusted for the qualitative materiality factors identified during audit planning. Instead, the auditor evaluates qualitative materiality separately and performs additional tests as necessary. An application of the disjoint method is illustrated in Figure 3. If the disjoint method was used for the example in Figure 3, the original (quantitative) planning materiality threshold would not be adjusted for the qualitative concerns identified by the auditor. Instead, the auditor should try to obtain assurance regarding the recording of registration transactions through additional methods and alternative procedures. Such methods may include observation of employees recording registration payments, analytical reviews to determine which employees consistently report shortfalls as well as when and where these shortfalls occur, etc. These tests would be in addition to the extent of testing determined by the tolerable misstatement or tolerable error.

Evaluation of Conceptual Framework

The separate identification and evaluation of qualitative materiality issues has advantages and disadvantages. The main advantage of the disjoint approach is that no adjustments to the current threshold of planning materiality and tolerable misstatement are necessary. However, a formal means of evaluating qualitative factors must be developed. This may include illustrative or concrete language to work papers that identify the qualitative aspects being evaluated or it may be more sophisticated and require identifying a separate audit cycle that requires specialized abilities, such as forensic or investigative auditing. Inherent limitations of the disjoint approach include: the possibility that all qualitative material items may not be identifiable (under-auditing); the lack of a way to identify relevant factors (under-auditing); and the auditor may unknowingly include inappropriate factors (over-auditing). On the other hand, specific tests can be designed and tailored to different requirements and the qualitative factors identified can be more completely analyzed.

The disjoint approach permits the carrying out of the same audit test with the appropriately reduced planning materiality threshold responsive to a sliding scale computation. Such integration of both qualitative and quantitative factors in one planning materiality threshold would not be generally appealing. Moreover, using this method may trap "smaller" errors that nevertheless have a significant impact on the financial statements taken as a whole. However, as noted before, the significant disadvantage is that in the cases where the sliding scale computation reinforces the quantitative materiality perspective and qualitative materiality aspects are largely ignored. Consequently, the disjoint approach may be inappropriate when sufficient lowering of the materiality threshold fails to occur because the severity of the qualitative risk dimension has not been recognized.

As stated above, the conjoint and disjoint methods are not mutually exclusive. In different audit situations, however, the two methods may be used together in certain audits. Deciding which method to incorporate for different situations is a matter of auditor judgment.

The governmental auditing profession could potentially reap significant benefits by adopting a comprehensive materiality framework in practice. Incorporating such a framework not only gives explicit consideration to qualitative materiality issues but also ensures that governmental auditors are in compliance with SAS No. 47 (AU 312) and the Yellow Book. In addition, the Chief Financial Officers Act of 1990 and other related developments seem to indicate that governmental entities to be run more like a business. Careful consideration of issues surrounding qualitative and quantitative materiality in well-publicized cases of fraud.

Conclusion

Government agencies are entrusted with a significant amount of public funds. Therefore, it is important that there exists a well-defined system of accountability to ensure these finances are managed prudently. Government auditors use materiality judgments to determine whether the used systems of accountability are operating effectively. A key component of overall materiality judgments is the consideration of qualitative materiality. Two alternatives for incorporating qualitative materiality have been identified in this article. The conjoint approach incorporates both quantitative and qualitative materiality and adjusts the quantitative materiality threshold for qualitative factors. The other method, the disjoint approach, considers qualitative and quantitative materiality factors separately in planning governmental audits.

While qualitative aspects have been considered in the past, it is difficult to establish an observable link to the samples chosen and the audit tests performed. However, this difficulty hardly justifies ignoring the unique significance of qualitative materiality in governmental audit planning. Whatever the reasons, it is clear that qualitative materiality as a concept has only been in the periphery of the auditor's vision. Indeed, there is reason to believe that qualitative materiality may not have been adequately considered in audits of government agencies experiencing large losses from derivative transactions, federally insured banksthat have become insolvent and in well-publicized cases of fraud. Formally recognizing the significance of qualitative materiality in planning governmental audits may give more confidence to support audits of the quality and audits of their quality.

Figure 3 Applying the Disjoint Approach: An Example

Two customer complaints regarding the improper accounting of vehicle registration at a particular Division of Motor Vehicle (DMV) location were reported in the local newspaper. The small number of incidents was determined by the auditor to be independent, isolated and immaterial. From a qualitative materiality standpoint, however, these incidents are not necessarily immaterial. The ability of these disgruntled customers to prove they had paid for their registration came into question. In the news article, it was suggested that the pattern of errors or irregularities is failing to be identified in the news article gives rise to serious cause for concern. The concern that the transactions were not recorded in the DMV's computerized registration system suggests a previously unrecognized internal control deficiency. Even a single customer complaint thus reflects a qualitative materiality issue.

References

End Notes


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