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# Materiality in Government Audit Planning

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

## Qualitative materiality

### 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.

**G**overnment agencies have large amounts of sensitive data on computer systems ranging from national security to individual citizens' financial histories. Because this information is sensitive, computer security becomes a critical issue. Suppose a newly elected, progressive and technologically savvy governor encouraged departments to move towards a paperless office environment. Further, suppose state agencies responding to the governor's suggestions find themselves deluged with glitches while installing new computer systems. While auditing access to computer files in a newly installed computer system, an auditor finds evidence that an unlogged call came in 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 a cost-benefit standpoint, tracing the source and nature of the call may appear unjustified. But the existence of this unlogged call is a qualitative materiality issue. Were there other errors in the computer program? Was other such access missed? 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 outcome of the scenario is that there 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 computer system. 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 investigative and settlement costs, in addition to the resulting public embarrassment. The foregoing illustration highlights a sort of "iceberg effect" wherein the small amount that is visible reveals little about the real nature of the problem.

The political sensitivity of the area under audit to adverse media exposure and litigation concerns the nature rather than the size of an amount, such as illegal acts, bribery and corruption, related party transactions, snowballing patterns of error and other risks that grow with time. Qualitative materiality considerations should not be ignored—they can and frequently do influence the nature and scope of governmental audits.

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#### **Guidance from Professional Literature and Standards**

**F**inancial Accounting Standards Board (FASB) Concepts Statement No. 2 defines materiality as the magnitude of an omission or misstatement that would influence the decisions of a user of the financial statements. Auditors use materiality in planning audits and in evaluating the effects of disclosures, or absence thereof, in financial statements. Statements on Auditing Standards (SAS) No. 47 (AU 312), which discusses audit risk and materiality in planning an audit, states that "As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." (Emphasis added)

AU 312 also requires auditors to consider audit risk and to make a preliminary judgment about materiality at the inception of a financial statement audit. The term risk, in a general sense, can be thought of simply as "the probability of something going wrong." The idea of risk, which underlies materiality judgments, is a qualitative notion. Further, value judgments regarding the assumed responsibilities of management to stakeholders (employees and the public) lie at the core of materiality

determination. It is possible to view risk as a measure of uncertainty and materiality as a measure of magnitude or size. Taken together they measure the uncertainty of amounts of a given magnitude. Unfortunately, quantitative materiality captures, at best, only a portion of the risk dimension and it is necessary to resort to qualitative materiality to obtain a more complete picture. The significance of qualitative factors in such measurement is evident.

It is true that auditors find it necessary to quantify the preliminary judgment about materiality as a practical matter. However, such quantification may divert attention from qualitative materiality. Contemporary auditing practice essentially interprets materiality judgments as referring to dollar thresholds or ranges, a predominantly quantitative perspective. A closer look at the FASB definition of materiality suggests otherwise: the term "magnitude" has a more comprehensive meaning and implies consideration of both qualitative and quantitative materiality. See Figure 1 for a definition and examples of qualitative materiality.

Qualitative materiality consists of intangibles that can be easily identified but, by definition, are not easily quantified. However, anecdotal evidence suggests that experienced auditors are somehow able to intuitively judge the degree of significance of the qualitative attributes of risk. Hence there is considerable value to generating a reasonably stable system of risk ranking—a uniform approach is far superior to having no such ranking system at all. Risk attributes may be represented on a continuum, an ascending numerical scale of importance, say from 1 to 10, with 1 indicating the least risk and 10 indicating maximum risk. A common approach to expressing subjective judgments on a quantified scale also helps achieve a reasonable amount of consistency in measurement. Once a risk ranking system is in place, auditors may judge risk attributes falling below specific landmark values or ranges on a subjective scale to be relatively less important than those lying at the high end of the scale. Clearly, risk attributes judged to be qualitatively important must be addressed and warrant relatively more audit effort. Of course, the difficulty lies in achieving consensus among auditors on the relative importance of risk attributes. Unless we find some feasible and defensible means of



characterizing qualitative materiality, we are likely to find auditors placing undue emphasis on quantitative materiality as a guide for their audit efforts.

Herzlinger asserts "...the performance of governments is shrouded behind a veil of secrecy that is lifted only when blatant disasters occur."<sup>1</sup> Because incidents such as the massive Orange County, California, derivatives losses are relatively rare, the complete absence or delayed nature of feedback regarding the results of an audit allows the effectiveness of governmental audits to remain uncontested. Consequently, government auditors who are concerned about the severe demands on their time and effort may choose to downplay the significance of qualitative materiality. However, because they deal with public funds, government auditors have additional fiduciary responsibilities, which introduces special risks that are usually qualitative in nature. Further, the public is increasingly strident in its demands for greater accountability in the public sector, in the form of more efficient and effective management of public aid programs, better conservation of scarce resources and more effective reporting. Consequently, the issue of qualitative materiality is going to become more prominent in the coming years.

### **Incorporating Qualitative Materiality: Conjoint and Disjoint Approaches**

**A**udit planning needs to incorporate considerations of audit effectiveness and audit efficiency. The efficiency of an audit pertains to the levels of time, cost and effort expended on component audit tasks. On the other hand, the effectiveness of the audit can be measured by the levels of goal-attainment, opinion accuracy, user-satisfaction and peer review. Auditors must carefully plan to ensure that an appropriate balance between efficiency and effectiveness is achieved during an audit. Poor assessment of the planning materiality for an audit can seriously compromise both audit efficiency ("over-auditing") and audit effectiveness ("under-auditing").

The remainder of this article presents several approaches to audit planning that provide more consideration of qualitative materiality, without denying the obvious importance of quantitative materi-

**Figure 1**

### **Qualitative Materiality: Some Illustrations**

Qualitative materiality refers to the nature of a transaction or amount and includes many financial and nonfinancial items that, independent of dollar amount, may influence the decisions of a user of the financial statements. Elements of inherent control and other subjectively expressed and intangible risks may be captured among certain qualitative materiality factors. For example, qualitative materiality factors with a strong inherent risk component might include political appointments, auditee's responsiveness to prior audit recommendations, level of technology implemented and observed error patterns and trends. Examples of qualitative materiality factors that could also be interpreted as internal control weaknesses might include, lax background check policies for new hires, poor disaster recovery procedures, ineffective safeguards over voluminous cash handling and inadequate supervision of key employees. Additional qualitative materiality factors may include, red flags arousing suspicions of fraud perpetration, lack of compliance with laws and regulations, changes in the long-term trends in account balances or ratios, quality of accounting personnel and efficacy of operational controls.

**Figure 2**

### **Applying the Conjoint Approach: An Example**

Each summer the State Fair rents the fairgrounds for special events. State law mandates that each time there is an event at the fairgrounds certain essential services must be made available, such as paramedics and ambulances. Contracts for these legally mandated services are open for bidding periodically. The head of the State Fair Park has the authority to award contracts less than \$10,000 without following sealed bid procedures. Because of the small dollar value of these contracts, the propriety of the awards has never been questioned in the past. The extraordinary success of the incumbent medical services contractor owing to his or her long-term association (15 years) with the State Fair Park is a qualitative issue. For example, why are other medical services firms not able to secure a contract with the State Fair Park? Unless the auditor makes an effort to evaluate these contracts it may not come to light that the head of the State Fair Park and the medical services contractor are siblings. Consequently, while planning the current audit, it is important to ensure contracts are appropriately awarded and disclosed. Potential conflicts of interest could result in profound embarrassment if, under such related party arrangements, the State Fair Park were found liable for the provision of inadequate or substandard medical services.

ality. Government auditors may consider quantitative and qualitative materiality issues together, the conjoint method, or separately, the disjoint method.

### **The Conjoint Approach**

**T**he conjoint approach incorporates quantitative and qualitative materiality into one audit

test plan, by making a suitable adjustment for their combined effect on the assessed materiality threshold. One way to do this would be to quantify the more intangible or qualitative aspects and express them on a predefined numerical scale or range. This adjustment factor can then be used to raise or lower the quantitatively expressed materiality thresholds previously determined, thus influencing the nature and extent

of testing to be performed. The application of the conjoint approach is illustrated in *Figure 2*, which shows that the relatively smaller dollar value 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 would most likely lower the quantitative materiality threshold previously determined. The auditor, by lowering the overall 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 awarding 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 effective for some situations, it neglects some crucial aspects and may not properly incorporate qualitative aspects in all situations. For example, suppose a proposed law has only an indirect effect on the financial statements. Lowering the planning materiality will surely increase the extent of testing performed, but may not adequately address the implications of the proposed law and the attendant impact on the financial statements. Following the conjoint method in these circumstances may have the undesirable outcome of an inefficient and ineffective audit. The auditor will need to plan tests 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 while planning and performing the audit. Under this alternative, the assessed quantitative materiality threshold is not adjusted for the

**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 with a personal check as identified in the news article gives rise to serious cause for concern. The fact 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.

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 be as simple as including 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 qualitatively material items may not be identifiable (under-auditing);
- the auditor may fail 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 conjoint 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 threshold is theoretically appealing. Moreover, using this method may trap "smaller" errors that nevertheless exert a cumulatively material impact on the financial statements taken as a whole. However, as noted before, the significant disadvantage seems to be in cases where the sliding scale computation reinforces the quantitative materiality perspective, and qualitative materiality aspects are largely ignored. Consequently, the conjoint approach may be inappropriate whenever 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 preferable 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 and quantitative factors 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 imply the need for government entities to be run more like a business. Careful consideration of issues surrounding materiality is imperative in helping governments to operate more efficiently and effectively.

## Conclusion

**G**overnment 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 established systems of accountability are operating effectively. A key component of overall materiality judgments is consideration of qualitative materiality.

Two alternatives for incorporating qualitative materiality have been iden-



tified 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 banks that have since become insolvent and in well-publicized cases of fraud. Formally recognizing the significance of qualitative materiality in planning government audits will provide for more effective audits. It will also generally blunt the public criticism targeted towards government auditors and the quality of their audits.

## End Notes

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