Name: Mussab Rehman

Roll: 16352

Program: B.B.A

Course: Mr. Quaid Iqbal

Section: B

Assignment: 1

**The materiality Principle**

Materiality in accounting refers to the significance of an overstatement or understatement of financial information. The accountant or financial reporter must determine if this misstatement or error is significant enough to cause an interested party with reasonable knowledge, such as an investor or business associate, to make an incorrect judgment. This definition omits an absolute limit that you must use to declare materiality limits, so you must rely on your professional judgment to form a basis for your calculations.

The materiality principle states that an [accounting standard](https://www.accountingtools.com/articles/2017/5/8/accounting-standard) can be ignored if the net impact of doing so has such a small impact on the [financial statements](https://www.accountingtools.com/articles/2017/5/10/financial-statements) that a user of the statements would not be misled. Under generally accepted accounting principles ([GAAP](https://www.accountingtools.com/articles/what-is-gaap.html)), you do not have to implement the provisions of an accounting standard if an item is immaterial. This definition does not provide definitive guidance in distinguishing material information from immaterial information, so it is necessary to exercise judgment in deciding if a [transaction](https://www.accountingtools.com/articles/2017/5/15/transaction) is material.

The [Securities and Exchange Commission](https://www.accountingtools.com/articles/2017/5/16/securities-and-exchange-commission) has suggested for presentation purposes that an item representing at least 5% of total [assets](https://www.accountingtools.com/articles/what-is-an-asset.html) should be separately disclosed in the [balance sheet](https://www.accountingtools.com/articles/2017/5/17/the-balance-sheet). However, much smaller items may be considered material. For example, if a minor item would have changed a [net profit](https://www.accountingtools.com/articles/2017/5/12/net-profit) to a [net loss](https://www.accountingtools.com/articles/2017/5/12/net-loss), then it could be considered material, no matter how small it might be. Similarly, a transaction would be considered material if its inclusion in the financial statements would change a [ratio](https://www.accountingtools.com/articles/2017/5/11/ratio) sufficiently to bring an entity out of compliance with its lender [covenants](https://www.accountingtools.com/articles/2017/5/4/covenant).

**Example:** A clearly immaterial item, you may have prepaid $100 of rent on a post office box that covers the next six months; under the [matching principle](https://www.accountingtools.com/articles/2017/5/14/the-matching-principle), you should charge the rent to [expense](https://www.accountingtools.com/articles/2017/5/6/expense) over six months. However, the amount of the expense is so small that no reader of the financial statements will be misled if the entire $100 is charged to expense in the current period, rather than spreading it over the usage period. In fact, if the financial statements are rounded to the nearest thousand or million dollars, this transaction would not alter the financial statements at all. The materiality concept varies based on the size of the entity. A massive multi-national company may consider a $1 million transaction to be immaterial in proportion to its total activity, but $1 million could exceed the [revenues](https://www.accountingtools.com/articles/2017/5/11/revenue) of a small local firm, and so would be very material for that smaller company. The materiality principle is especially important when deciding whether a transaction should be recorded as part of the [closing process](http://www.accountingtools.com/closing-the-books-course), since eliminating some transactions can significantly reduce the amount of time required to issue financial statements. It is useful to discuss with the company's [auditors](https://www.accountingtools.com/articles/2017/5/5/auditor) what constitutes a material item, so that there will be no issues with these items when the financial statements are [audited](https://www.accountingtools.com/articles/2017/5/7/audited-financial-statements).

**Similar Terms:**

The materiality principle is also known as the materiality concept.

**Basis:**

No accounting standard has defined an absolute basis of determining materiality; the financial industry commonly uses 5 percent of net assets. Materiality is not a one size fits all, and the method one organization uses may not be appropriate for all organizations. A 5 percent threshold or even a percentage of net assets is not the only guideline organizations use. You can also use a relationship to your revenues to determining materiality. Whichever method you choose, the rule of thumb is to apply your predetermined percentage to a base amount, whether it's total assets, revenues or specific book values.

**Other Concerns:**

Items defined as immaterial may still have a substantial impact on your company’s overall financial position or performance. In this case, even though the item meets the immateriality definition, you must treat it as a material item. For example, consider an overstatement in depreciation calculation that makes the profit just $10 short of falling in the taxable range. If you recalculated the depreciation, the overall profit would increase, making it taxable. This error, although amounting to a small amount, alters an investor's judgment and is thus considered material

**Variations in Materiality:**

Materiality varies based on the size of an organization. For a large corporation with revenues exceeding billions of dollars, a million-dollar transaction might not mean much. However, this “small” figure might be more than the revenues of several small businesses combined. Materiality, therefore, has to be defined separately for each organization and cannot be compared among organizations. When organizations use the standard methods, the materiality amount automatically changes according to size, which is measured in terms of revenue, assets, equity or whatever base amount the organization selected.

So the materiality Principle is not only protected the shareholder’s and investors’ interest but also help to account for preparing its Financial Statements.

Base on this principle, the account could know what material is and what is immaterial. They also know what should be separately disclosed and what should be included with other transactions.