

ISA (UK) 320 Materiality in Planning and Performing an Audit (Lecture A647 – 10.08 minutes)

ISA (UK) 320 *Materiality in Planning and Performing an Audit* deals with the auditor's responsibility in applying materiality and performance materiality in an audit of financial statements. ISA (UK) 320, paragraph 2 states that:

'... Although financial reporting frameworks may discuss materiality in different terms, they generally explain that misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.' ISA (UK) 320, para 2

If the financial statements contain material misstatement, they cannot be deemed to show a true and fair view.

The focus of the audit is to identify the significant risks of material misstatements within the financial statements and then apply appropriate audit procedures which are aimed at identifying and quantifying material misstatement.

There is no 'one-size-fits-all' in ISA (UK) 320 as to how materiality should be calculated – the auditor's determination of materiality is a matter of professional judgement. It will be affected by the auditor's perception of the financial information needs of users.

Arriving at a materiality level

As noted above, materiality is based on professional judgement and factors which the auditor must consider when determining a materiality level usually include (among other things):

- whether the misstatement would affect the economic decision-making of the users;
- the size and nature of misstatements; and
- the information needs of the users as a group.

It is not practicable to design audit procedures which aim to detect all misstatements, but the auditor must consider the nature of potential misstatements and design relevant audit procedures to address the risks of material misstatement. In addition, the auditor must not only consider the size of uncorrected misstatements, but must consider the nature of them together with the particular circumstances of their occurrence.

Material by size

The use of an 'averaging' method is common among audit firms. The following benchmarks may be used as a starting point:

½ - 1% of turnover

5 – 10% of pre-tax profit

1 – 2% of gross assets

Under the averaging method, an average is then struck and this is used as the financial statement materiality level. However, keep in mind that this method is not the only method that can be used and also may not be appropriate. Indeed, different benchmarks or different thresholds may be used depending on the client.

Also, keep in mind that it may not necessarily be appropriate to base materiality on, say, turnover. For example, where the client has inappropriately capitalised research expenditure, judging the materiality of the issue against revenue is unlikely to be useful; it would be appropriate to use gross assets and pre-tax profit to measure the materiality of the inappropriately capitalised expense.

Example – Materiality levels

		Financial statement extracts:	
		2018	2017
		£'000	£'000
Turnover		21,350	19,770
Gross assets		9,124	7,359
Pre-tax profit		1,022	349
			<u>Materiality</u>
Turnover		<u>½%</u>	<u>1%</u>
		107	198
Pre-tax profit		<u>5%</u>	<u>10%</u>
		51	35
Gross assets		<u>1%</u>	<u>2%</u>
		91	147
As an average (preliminary materiality)		<u>83</u>	<u>127</u>

However, a suitable materiality level is most likely to be one that lies within the overlap of the ranges calculated for profit and total assets. £91,000 (1% of gross assets) represents 9% of pre-tax profit. As this is at the lower end of the asset range, this may be a prudent measure of materiality resulting in a higher level of audit work. In addition, where draft financial statements are concerned, there is a higher risk of errors and consequently sample sizes for audit testing should be increased (ie preliminary materiality should be set at a relatively lower level) and hence the average of £83,000 may be used.

Material by nature

Materiality is not just concerned with the numbers in the accounts. Some items within the financial statements may be material by nature (ie the impact they have on the financial statements), such as:

- misstatements which, when adjusted, would turn a reported profit into a loss;
- misstatements which, when adjusted, would turn reported net assets into a net liability position (or net current assets to net current liabilities);
- directors' transactions such as remuneration and advances, credit and guarantees during the year;
- contingent liability disclosures; and
- related party disclosures.

Performance materiality

Auditors cannot design procedures which aim to find every misstatement in the financial statements – indeed this would be impracticable. It is more likely that misstatements are material in aggregate and for this reason, ISA (UK) 320 includes a further concept of performance materiality.

ISA (UK) 320, paragraph 9 states:

'For purposes of the ISAs (UK), 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 a 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 (UK) 320, para 9

Therefore, the auditor sets performance materiality at a level lower than overall financial statement materiality and uses this lower threshold when designing and performing audit procedures. So, for example, if performance materiality is £20,000 then any trade debtors in an after-date cash sampling test at or over £20,000 would be included in the sample.

Example – Performance materiality

The audit senior is planning an audit of Sycamore Ltd for the year-ended 31 October 2018. She has determined a materiality level for the financial statements as a whole of £95,000. Work in progress has been identified as containing a higher risk of material misstatement and hence performance materiality needs to be applied to this area.

As with financial statement materiality, there is no pre-determined calculation for performance materiality. The audit senior will determine performance materiality as a percentage of financial statement materiality (say 75%) and hence performance materiality will be (£95,000 x 75%) £71,250. The audit senior could, however, use a higher or lower percentage depending on her professional judgement.

The aim of performance materiality is to reduce the risk that the aggregate of immaterial misstatements exceeds materiality for the financial statements as a whole.

Using the above example, where a misstatement was identified of, say, £80,000 without performance materiality, the audit senior would have concluded that work in progress does not contain material misstatement. However, the audit may not have detected further misstatements which, when added to the £80,000, would result in a material misstatement. The use of performance materiality means that the audit senior would conclude that a misstatement of £80,000 is material and hence would require the directors to amend the financial statements to correct this misstatement, which in turn reduces audit risk (the risk that the auditor expresses an inappropriate opinion).

Revisions to materiality

Materiality levels are not just calculated at the planning stage of the audit and then forgotten about. ISA (UK) 320 requires the auditor to revise materiality for the financial statements as a whole (and, where applicable, the materiality level(s) for particular classes of transactions, account balances or disclosures) when the auditor becomes aware of information which would have caused them to have determined a different amount(s) initially.

When the auditor concludes that a lower materiality level for the financial statements as a whole (and, where applicable, materiality level(s) for particular classes of transactions, account balances or disclosures) is necessary, the auditor must also determine whether it is necessary to revise performance materiality also. In addition, the auditor must also determine whether the nature, timing and extent of further audit procedures remains appropriate.

Documentation

ISA (UK) 320 requires the auditor to include the following amounts and factors considered in their determination of materiality in the audit documentation:

- materiality for the financial statements as a whole;

- if applicable, the materiality level(s) for particular classes of transactions, account balances or disclosures;
- performance materiality; and
- any revisions to materiality levels as the audit progressed.