

Materiality (Lecture A799 – 10.48 minutes)

Materiality is dealt with in ISA (UK) 320 *Materiality in Planning and Performing an Audit*. Materiality is concerned with misstatements and omissions. Misstatements and omissions are 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.

Essentially, if the financial statements contain material misstatement, they cannot be said to give a true and fair view. The Companies Act 2006 prohibits the directors from approving financial statements that do not give a true and fair view.

The focus of the auditor is identifying the significant risks of material misstatement and then designing audit procedures which are responsive to those risks.

Materiality is purely judgemental. There is no 'one-size-fits-all' where the concept of materiality is concerned; indeed, what could be material in one entity may not be material in another. In determining whether a misstatement or omission is material, the auditor must consider:

- whether the misstatement would affect the economic decisions of the users;
- the size and nature of the misstatements (some misstatements may be immaterial in monetary terms (quantitative) but could be material in nature (qualitative); and
- the information needs of the users as a group.

1.1 Material by size

In practice, materiality is calculated using various benchmarks, the most common being:

- ½ to 1% of revenue
- 5 to 10% of profit before tax
- 1 to 2% of total assets

These percentage figures are useful as a starting point, but it is worth emphasising that they are **not** prescriptive and different auditors may use different percentages depending on their risk assessment. However, it would usually be inappropriate to use percentages larger than these limits because otherwise materiality will end up being too high and audit risk will increase.

Some audit firms use an 'averaging method' so will calculate the above figures and then divide the total by three to arrive at a financial statement materiality. Increasingly, regulators have indicated that this is not an appropriate method to reach a materiality figure, as it does not focus appropriately on where the risks arise. Hence, the auditor should consider which of the above figures are most pertinent and may make adjustments based on all three, if these are fully justified with the reasons and the thought process documented.

Example – Misstatement identified

During the audit of Sunnie Limited, the audit senior noted an amount of research expenditure that had been capitalised as an intangible asset in contravention of FRS 102, Section 18 *Intangible Assets other than Goodwill*.

When calculating the materiality of this misstatement, the auditor could assess it against the performance materiality. However, for items that affect a particular balance, it may be appropriate to select a materiality figure based on the item that will be affected. Hence, the auditor would assess the misstatement individually against the benchmark used for pre-tax profit and total assets. If the misstatement was, for example, 2.5% of total assets and 3% of profit before tax, the misstatement would still be material in isolation as it goes over the 1-2% of total assets benchmark so would need to be corrected to avoid a modified audit opinion.

1.2 Material by nature

Materiality is not just concerned with the monetary values in the financial statements. There are some issues which could affect the financial statements and are considered to be material by nature, for example:

- Disclosures about a material uncertainty related to going concern
- Material related party transactions that have not been adequately disclosed
- Disclosures concerning transactions with directors
- Contingent liability disclosures which, if omitted, may impact on the usefulness of the financial statements
- Misstatements which, if adjusted, would cause a profit to turn into a loss
- Misstatements which, if adjusted, would cause net assets to turn into net liabilities

Materiality levels are calculated at the planning stage, but they must be revised throughout the course of the audit if issues arise that cause the audit plan to be changed. The level of adjustment to the materiality levels will all depend on the issues that have arisen, but consultation with the audit engagement partner must be undertaken prior to any revisions to ensure that any amendments to materiality are appropriate.

In addition, the materiality levels must be reassessed at the end of the audit to ensure that they remain appropriate. In certain situations, it may be necessary to perform further audit procedures at the completion stage, particularly if the level of uncorrected adjustments approaches materiality.

1.3 Performance materiality

Performance materiality is defined in ISA (UK) 320, para 9 as follows:

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

Where performance materiality is concerned, the auditor sets this at a lower level than the overall financial statement materiality level and uses this lower threshold when designing and performing audit procedures (in other words, it is used as a basis for testing transactions). This reduces the risk that the auditor will not identify misstatements which are material when aggregated.

Example – Calculation of performance materiality

The audit engagement team is planning the audit of Harper Ltd for the year ended 31 August 2022. The audit senior has calculated financial statement materiality to be £86,000 and the general level of performance materiality has been calculated at 75% of this (£64,500). The senior has identified work in progress and development expenditure as having a high risk of material misstatement, hence a specific level of performance materiality needs to be applied to these areas.

The audit engagement partner has suggested that 50% of the financial statement materiality level be used in these high-risk areas. Hence, when auditing work in progress and development expenditure, a performance materiality of £43,000 (£86,000 x 50%) should be applied.

Depending on the level of risk of material misstatement, the auditor could apply a higher or lower percentage to this 'haircut' of the financial statement materiality to give performance materiality or even use a different calculation. This will be down to professional judgement and that judgement should be carefully documented.

In the example above, specific performance materiality is £43,000. If the auditor had not used this specific performance materiality and then discovered a misstatement of, say, £70,000 in the work in progress valuation, the auditor may have concluded that the misstatement is immaterial when measured against financial statement materiality of £86,000. However, the auditor may not have detected further misstatements which, when added to the £70,000 figure, could have resulted in material misstatement. By using performance materiality, the misstatement of £70,000 would be considered material by the auditor and hence the auditor would request management to correct the misstatement, and this reduces the risk of the auditor expressing an inappropriate opinion.

It is worth noting that ICAEW guidance suggests a performance materiality of 75% for low risk areas of the audit and 50% for those considered high risk. In the FRC thematic review, the vast majority do not go over 75% and only one listed audit went above 80%.

A general level of performance materiality is required to be used in planning and to determine the extent of testing required. The level of performance materiality is a matter of professional judgement but research in the form of the *FRC Audit Quality Thematic Review – Materiality* issued in December 2017 has shown the percentage reduction in financial statement materiality to get to performance materiality is usually between 20% and 60%. First year audits typically require a lower level of performance materiality to mitigate the risks of auditing an unfamiliar set of accounts.

As with financial statement materiality levels, performance materiality levels are revised during the audit work, where necessary. A reduced level of performance materiality would be appropriate when facts come to light which the auditor was not previously aware and which increases the risk of material misstatement (for example, an undisclosed related party).

1.4 Clearly trivial misstatements

As well as documenting the levels of financial statement and performance materiality, the auditor is also required to document the level below which misstatements are clearly trivial. This is part of the requirements of ISA (UK) 450 *Evaluation of Misstatements Identified During the Audit* which requires all misstatements found during the audit (other than those which are clearly trivial) to be accumulated.