

## Materiality (Lecture A835 – 12.25 minutes)

ISA (UK) 320 *Materiality in Planning and Performing an Audit* provides guidance to auditors on both financial statement materiality and performance materiality.

Materiality calculations are often challenged during audit file reviews – particularly where the ‘averaging method’ is used and so it is worthwhile recapping on some of the issues so that audit firms can ensure their materiality calculations are appropriate in the client’s circumstances.

ISA (UK) 320 refers to materiality in the following way:

*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 (extract)

In this way, you can think of materiality as a way for the auditor to prioritise the elements of the financial statements which need more attention. Essentially, it is a way of managing audit risk – the more material an element of the financial statements, the more audit attention it is likely to require, to ensure that the appropriate audit opinion is provided.

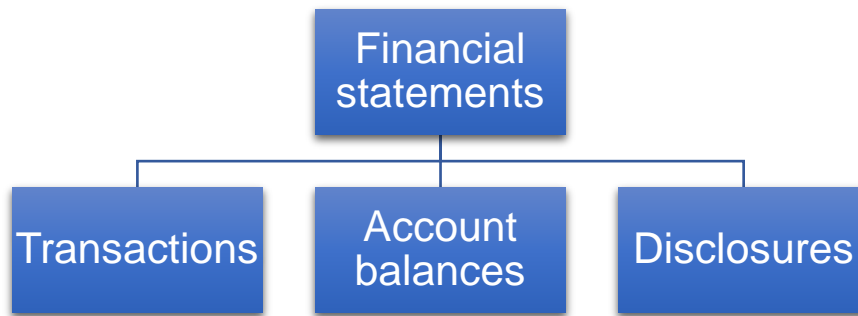
Materiality is a wholly judgemental issue and can be revised during the course of an audit. It is set at the planning stage based on the draft financial statements or other sources of financial information. If matters come to light during the audit which the auditor was not previously aware of, the auditor may choose to increase or decrease materiality levels as appropriate.

### 1.1 Material classes of transactions, account balances and disclosures

ISA (UK) 320 contains the fundamental requirement relating to materiality as follows:

*When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.* ISA (UK) 320, para 10

Financial statements are split into transactions: items in profit and loss and other comprehensive income; account balances: items in the balance sheet and disclosures.



**Transactions** include turnover, purchases, payroll and other expenses, income received from financial investments, interest payable and similar expenses and tax.

**Account balances** include assets, liabilities and equity.

**Disclosures** are information in the notes to the financial statements, including material accounting policy information and other notes required by UK and Ireland GAAP, legislation and regulation.

The auditor is concerned with material classes of transactions, account balances and disclosures to ensure there is no material misstatement. Immaterial account balances and disclosures will not be a major concern on the grounds of their immateriality, but that is not to say they can be forgotten about entirely during the course of the audit – immaterial transactions, balances and disclosures may become material if there are any revisions to materiality levels during the course of the audit. It is clear during some file reviews that immaterial items are completely ignored at the completion phase even though there is a risk they may become material when combined.

An item in the financial statements should be considered from different viewpoints in order to determine its materiality. An item could be material from one point of view, but immaterial from another point of view. The important thing to remember is that materiality should be judged from the perspective of the users of the financial statements.

## 1.2 Applying materiality

When considering materiality, there is no 'set method' for deciding whether something is material or not – the auditor uses their professional judgement to make this decision, using the framework set out in ISA (UK) 320.

ISA (UK) 320 confirms the importance of professional judgement when determining materiality by stating:

*Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and*

ISA (UK) 320,  
para 2 (extract)

*Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.*

The auditor's objective is to obtain sufficient appropriate audit evidence over the figures that appear in the financial statements and that the auditor is also concerned with ensuring that the narrative information relevant to the financial performance, financial position and cash flows is complete and accurate. The auditor must also consider the overall impact that immaterial misstatements may have on the financial statements when they are combined, for example, could they turn a reported profit into a loss?

There are two important factors to consider where materiality is concerned: whether an item is material by **size** or whether it is material by **nature** – in other words, there are both qualitative and quantitative factors in respect of materiality.

ISA (UK) 320 does not specify a calculation for materiality because it recognises that it is down to the auditor's professional judgement. However, percentage 'benchmarks' can be a useful starting point, such as, depending on the circumstances:

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

These benchmarks are common, but are not definitive. Different audit firms may use different benchmarks or different thresholds for each client. For a profit-orientated entity, a benchmark based on profit before tax is commonly applied. However, materiality should be assessed each year and the method may need to change in response to new circumstances. For example, if profit before tax becomes volatile, the auditor may no longer conclude that it is an appropriate benchmark, so could decide to use a different benchmark, such as gross profit, total revenue or a normalised profit figure.

Increasingly, professional bodies are advising that the auditor documents their thought process when it comes to establishing materiality levels as ISA (UK) 320 requires the auditor to document the factors considered in the determination of materiality. This is so that the rationale behind the determination of materiality can be understood. This is important because the calculation of materiality cannot just be viewed as a 'mechanical' part of planning; the financial statement and performance materiality levels should be justified as to their appropriateness to the audit.

Some audit firms use the 'averaging method' which use the benchmark figures above and then divide the sum of these by three to arrive at an average financial statement materiality level. While there is nothing in ISA (UK) 320 that suggests this is wrong, regulators have indicated that this is not an appropriate method as a basis of calculating materiality. This is on the grounds that the averaging method does not focus appropriately on where the risks arise.

## Performance materiality

ISA (UK) 320 defines 'performance materiality' as:

*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 levels for particular classes of transactions, account balances or disclosures.*

ISA (UK) 320,  
para 9

Performance materiality is therefore a level of materiality which is set **lower** than financial statement materiality. It is this lower level of materiality that is used when designing and performing audit procedures (i.e. it is the level used in testing). For example, if performance materiality for trade debtors is £40,000 then all individual trade debtor balances exceeding £40,000 are included in the sample.

### 1.3 FRC Thematic Review on materiality

In their 2017 Thematic Review on Materiality, the FRC found that the most common way to determine a materiality threshold (in their survey of the eight largest audit firms) is based on 5% of profit before tax.

The FRC commented that:

*It may be appropriate to use a profit-based measure for some sectors, such as construction, general retailing and support services; in others, such as mining and equity investment instruments, however, earnings before interest, tax depreciation and amortisation (EBITDA) and net asset values may be more appropriate.*

FRC Thematic  
Review on  
Materiality

This highlights the fact that auditors need to use their judgement when determining how to apply materiality – the same approach will not be suitable for all audit clients. This is why it is important to document the rationale behind the materiality calculation as noted earlier.

In addition, the Thematic Review noted that some firms use materiality benchmarks based on a rolling average, which should work to eliminate volatility in profits and therefore in the materiality benchmark applied in audits of clients in industries where profit volatility is also prevalent.

One of the significant findings of the Thematic Review was that there is a considerable difference in how audit firms determine materiality, with some audit firms using considerably lower materiality levels than others on their audits. Perhaps this is not too surprising given the extent of professional judgement that needs to be used when setting a level of materiality for audit clients. In the Thematic Review, the FRC comments that it is possible that the materiality levels set by some firms could be around 100% higher than that of the more prudent firms. These different approaches to materiality could lead to significantly different audits being conducted, impacting on the scope and detail of audit work performed and possibly on the conclusions reached by the audit firm.

The Thematic Review also encourages audit committees to engage with their audit provider to discuss and, where necessary, challenge the auditor's determination of materiality. The Thematic Review reported that only 17% of audit committees have engaged with their auditor regarding materiality which goes against the principle that the audit committee should monitor the quality and effectiveness of the external audit.

#### **1.4 Materiality and audit risk**

Audit risk is the risk that the auditor expresses an incorrect opinion on the financial statements. The auditor must try to reduce audit risk to the lowest possible level, although the reality is that they cannot remove audit risk entirely.

There is an inverse relationship between materiality and the level of audit risk. Hence, the higher the assessed level of audit risk, the lower the level of materiality and vice versa. Another way of thinking of this is that if the auditor wishes to reduce audit risk, they should reduce the materiality level – this means that more balances, transactions and disclosures will become material (based on quantitative materiality) and larger sample sizes will be used to obtain audit evidence.

##### **Example – Inverse relationship between audit risk and materiality**

During the audit of Howard Enterprises Ltd, the auditor discovers significant weaknesses in the controls over the payroll cycle.

The payroll department has weak segregation of duties and a lack of authorisation controls in place. During the last four months of the financial year, there had to be significant revisions made to the company's payroll due to mistakes made in the processing.

In this situation, there is a high audit risk relating to payroll transactions. The auditor reduces audit risk by reducing materiality levels hence there is a higher likelihood that the auditor will detect more misstatements by performing more audit procedures on payroll. In this example, the auditor is using materiality as a way of reducing their audit risk exposure.

The example above also demonstrates that materiality does not remain 'fixed' during the course of the audit. Matters may come to light during the audit fieldwork process that may cause the auditor to revise materiality levels either upwards or downwards depending on the issues identified. Where misstatements, fraud risks or weaknesses/override of internal controls are identified, the auditor is likely to increase materiality levels and carry out a more substantive approach to testing.

In fact, this is a requirement of ISA (UK) 320 which requires the auditor to revise the level of materiality during the audit in the event of becoming aware of information that would have caused the auditor to have determined a different amount(s) initially. This can happen, for example, if the initial assessment of materiality is based on projected financial information, and the actual financial results for the period turn out to be quite different to the projections.

