

Article: Materiality and its Practicalities

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P1 Auditing

Introduction

International Standard on Auditing (UK and Ireland) 320 "Materiality in planning and performing an audit" (ISA 320) explains that mmisstatements and omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users of the financial statements. The users are considered as a group of users of the financial statements rather than as individual users. This article attempts to explain the practicalities of materiality, including how it is calculated for various types of business and when performance materiality is used.

The concept of materiality is applied by the auditor both in planning and performing the audit, and also in evaluating the effect of identified misstatements (adjusted or unadjusted) in the financial statements - see ISA (UK and Ireland) 450, "Evaluation of Misstatements Identified during the Audit." In addition, the auditor also uses materiality when forming the opinion in their auditor's report.

Initial issues concerning materiality calculations arise because the auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. Further judgment comes into play when deciding whether a misstatement or omission is immaterial, as although it may be below the calculated materiality level, by its very nature it is material to the users of the financial statements and should therefore be adjusted and/or disclosed in the financial statements e.g. related party transactions.

Calculating materiality

The first consideration when calculating materiality at the planning stage is the assessed risk associated with the business. There is an inverse relationship between risk and materiality. The higher the assessed risk of material misstatement within the financial statements, the lower the materiality and vice versa. This means that larger samples will be selected in response to the higher assessed risk and as such low materiality results in larger samples, higher materiality levels result in smaller sample sizes.

There are a number of benchmarks which can be selected to help calculate materiality and a range of materiality percentages that could be used when calculating materiality. ISA 320 doesn't specifically mention the ranges of percentages that can be used as again this is left to the auditor's judgment, however, common percentages used are

shown below. Ideally the one selected by the auditor should be the benchmark that most represents the needs of the users of the financial statements. Examples of the more common benchmarks and percentages are as follows:

- Revenue (0.5% to 1%)
- Total Assets (1% to 2%)
- Net assets (2% to 5%)
- Profit after tax (5% to10%)

Remember if assessed risk is high then the lower percentages for calculating materiality will be selected. If assessed risk is low then the higher percentages will be used.

The auditor must use their professional judgment including knowledge of the business, the industry it operates in and the needs of the users of the financial statements to identify the most relevant benchmark to use. Some auditors use three or four benchmarks and take an average for materiality calculations. This might be suitable for a first year audit, however, it is probably best for recurring work that more professional judgment comes into play based on previous experience and knowledge. For example, for a business intent on making profits for its shareholders and paying regular dividends profit benchmarks might be more suitable. On the other hand a small owner managed business with marginal profits might want to take net profit before tax and owner remuneration as the best measure to use. For a business concerned with asset growth e.g. property development / management, then an asset based benchmark would be a better measure to use. For retailers, then revenue or profit after tax would be more suitable.

For other businesses, it might be more suitable to select a different measure than the ones outlined above e.g. a not for profit organisation or a public sector body could use 0.5% to 1% of expenses since they are normally not concerned with revenue generation or profits. On the other hand a not for profit organisation with a large asset base including investment portfolios, then an asset benchmark would be better.

For business with fluctuating results then it might be best to look at previous years' results and take a normalised figure on which to base materiality calculations.

From the above, it should now be clear the extent of judgment required by the auditors when calculating materiality at the planning stage. This article has only looked at calculating materiality for the financial statements as a whole. Indeed there may also be separate balances and classes of transactions that require a much lower materiality figure to be used than the one calculated for the financial statements as a whole, since misstatements of a lesser amount than materiality in these particular balances or classes of transactions could reasonably be expected to influence the economic

decisions of the user. In considering whether, in the specific circumstances of the organisation, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance materiality

ISA 320 states that "Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole".

The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period. In general, many auditors are using 60% to 75% of materiality as reasonable estimates of performance materiality. When looking at the schedule of unadjusted errors, the aggregate of this will be compared with the performance materiality figure to decide whether the financial statements require further adjustment. Thus giving the auditor greater comfort that the financial statements are free from material misstatement whether caused by fraud or error.

Disclosure

Finally, this article will outline what disclosures are required under ISA 320. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

- (a) Materiality for the financial statements as a whole;
- (b) The materiality level or levels for particular classes of transactions, account balances or disclosures, if applicable;
- (c) Performance materiality; and
- (d) Any revision of the above as the audit progresses.