

CHAPTER 2

Understanding materiality in the context of the financial statements audit

This article aims to:

Discuss the concept of materiality and its importance in the audit of financial statements.



When establishing the overall audit strategy, an auditor determines 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 would also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor would determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

In this article we will discuss the concept of materiality, how is it determined and how does it impact the audit of the financial statements.



What is materiality?

Ind AS 1, *Presentation of Financial Statements* states that 'material omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor'. Therefore, omission or misstatement which could influence the decision of the users of financial statements is said to be material. The concept of materiality is therefore fundamental to the audit. It is applied by auditors at the planning stage and considering that auditors should design their audit in such a way that there is a reasonable possibility that all material misstatements are detected during the audit.

In order to achieve the above objective, an auditor determines an appropriate materiality amount, and the audit scoping is based on this amount. Therefore, materiality is the most critical element of an audit which drives the way an audit is planned and also the manner in which it is performed.

Determining materiality

Determining materiality is a key judgement area for an auditor and it is determined at the time of planning an audit. While an auditor should consider the needs of the users of an entity's financial statements when determining the appropriate benchmark, they should also consider nature of the entity and the industry in which it operates as a factor on which to base their materiality calculations.

Generally, Profit Before Tax (PBT) is considered to be the most important metric for any user of financial statements and hence it is considered to be the most appropriate benchmark for determining materiality. In many cases, materiality can be set in a range of 3 to 10 per cent of PBT depending upon various other factors like whether a company is listed or unlisted (at the lower end of the range for listed entities), whether financial covenants of debts are sensitive to operating results, stability of business environment, sensitivity to earnings per share, etc.

In case an entity is in a loss, Loss Before Tax from Continuing Operations (LBTCO) may still be the relevant benchmark in case it most influences the judgement of the users of financial statements, and it represents the normal operations of the entity and is in line with the management's budget and strategy.

In case of certain industries, even if an entity's normal margins are low, for example, retail industry, Profit Before Tax from Continuing Operations (PBTCO) would continue to be the appropriate benchmark.

Different approaches to materiality benchmarks

In certain situations, PBT may not be considered as an appropriate benchmark to determine materiality. These may be situations like when the users of the financial statements may not focus on PBT and hence, other metrics like revenue, total assets, etc. may be considered as a benchmark to determine materiality, depending upon which metrics is most important to the users of financial statements. Different situations in which a benchmark other than PBTCO may be considered to determine materiality are as follows:

- Investments funds or trusts where the presumed benchmark for determining materiality is likely to be total assets since the focus of the users would be on total assets considering the nature of the industry.
- Entities that trade mainly for capital gains for example, investment property companies, the presumed benchmark is most likely to be total assets since profit in such entities would be generated through increase in the value of the underlying assets. However, it is important to

note that merely having a large asset base does not mean that the focus of the users is on the total assets, and it becomes the benchmark, even though it may be a relevant metric e.g. banks, insurance companies, airline companies, mining companies, etc. where the benchmark is likely to be PBT.

- Start-up entities that are predominantly focussed on capital expenditure or asset development and have not yet earned significant revenues or profits, total assets are the likely benchmark. Conversely, start-up entities that are not focussed on capital expenditure or asset development are likely to have total expenses as the benchmark.

Further, there could be situations where there can be a change from the generally applicable PBT benchmark to some other metric like total revenue or total assets or net assets, etc. in the following situations:

- a. Change in the focus of the users of the financial statements:** The common scenarios where there can be a change in the focus of the users are:
- Change in the life cycle, for example, from start-up to growth.
 - Significant business acquisition during the year that changed an entity's primary industry.

- Entity is going through a period of low profitability during a restructuring exercise and the users are currently focussed on sustainability and growth of revenue rather than short term profit.

b. Volatility on PBT/LBT: When PBT/LBT is volatile, an auditor can first assess whether they can normalise the PBT/LBT by adjusting or averaging for any non-recurring items, prior to considering a more stable metric like total revenues or net assets or another relevant metric as the benchmark for determining materiality.

Determining performance materiality

Having determined materiality, the auditors then determine a performance materiality. SA 320, *Materiality in Planning and Performing an Audit* defines performance materiality as 'the amount or amounts set by an 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 an auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. To explain this in simple terms, the audit is planned and

performed to detect material misstatements, it is possible that a number of individually immaterial misstatements may cause the financial statements to be materially misstated. To address this risk, the audit is performed at a lower materiality called performance materiality, such that it reduces the aggregation risk at an acceptable level i.e. the risk that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole (aggregation risk).

Setting the performance materiality is a judgemental matter and is affected by an auditor's understanding of the entity specific factors like deficiencies in entity-level controls, number and severity of deficiencies in control activities including pervasiveness of internal control deficiencies, history of misstatements that were accumulated in the audit of the financial statements of prior periods (both corrected and uncorrected), level of turnover of senior management or key financial reporting personnel, management's preparedness/willingness to correct misstatements, etc. Depending on the extent to which these factors apply, performance materiality could be determined to be in the range of 85 to 50 per cent of the materiality amount.

Performance materiality affects the amount of audit work to be performed in a number of ways. Performance materiality is used to scope areas of the financial statements and business and activities (components) of groups that will be subject to audit. However, there could be other qualitative factors, due to which amounts lower than the performance materiality can be selected for audit, for example, managerial remuneration can be important to users. Hence, even though it may be below the performance materiality, an auditor may audit it due to the qualitative considerations.

Other consideration relating to materiality

In case of a first-time audit engagement (audit that have been previously audited by a predecessor auditor), it would be difficult for an auditor to assess the factors to be considered for determining performance materiality, as mentioned above, in the absence of previous experience of auditing the entity. In such a case, due to the absence of sufficient information to assess aggregation risk, an auditor may consider the aggregation risk to be on a higher side.

Other than the presumed benchmark, there would be other relevant metrics which are considered important to the users of the financial statements based on the auditors' understanding. An auditor considers what is important to the users and considers those as other metrics. Generally, for profit seeking entities, other metrics would be total revenues, total or net assets.

If there is one or more particular significant account or disclosure for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the decisions of users taken on the basis of the financial statements, an auditor should also determine lower materiality level to be applied to those particular significant accounts or disclosures. For example, a company has introduced a new product segment in the last couple of years which is likely to be the most significant product segment in the coming years,

the auditor may determine a lower materiality for this product segment, even though it may be lesser than the performance materiality currently, but considering the users focus on the revenue growth in this product segment, an auditor determines that a smaller misstatement in that product segment revenue would be material to the users. Therefore, an auditor establishes a lower materiality for that product segment revenue.

A benchmark once determined is expected to continue from the previous period. However, it may be appropriate to change the benchmark from the prior period, when there is a significant change in the circumstances of an entity. A change in circumstance of an entity may include a change in business model, disposal of a major operating segment or in cases where entity has been consistently making profits and now has become a loss-making entity or vice-versa due to change in the circumstances of the entity, such that the needs of the users of the financial statements have changed significantly from the previous year. Additional changes to circumstances could include change in the entity's life cycle (for example from start-up to growth phase) or change in the entity's primary industry on account of an acquisition/ restructure, etc. or situations where an entity is going through a period of low profitability such that the focus of the users is on sustainability and revenue growth instead of short-term profits.

Once the materiality amount is determined at the stage of planning, it is required to be reassessed as the audit progresses since there may be events and conditions which may include not only quantitative changes to the metrics and financial statements' amounts but also changes affecting the auditors' consideration of other qualitative factors. Reassessing materiality helps the auditor confirm that it is appropriate for the circumstances and allows them to perform appropriate audit procedures.

In certain jurisdictions like in UK, auditors are required to communicate in their audit report the materiality considered by them in auditing and the basis for determining it. The other element of materiality which is important to understand is materiality calculated during a group audit scenario. Materiality is calculated for each of the component which is scoped in for group audit (the extent of audit procedures on each of these components can vary depending on the relative size and qualitative attributes of the component). In case the component auditor is also required to do statutory audit, the audit procedures would need to be performed by the component auditor using the lower of either component materiality allocated by the group or the materiality determined as the statutory auditor of that component.

Lastly, as required by SA 260 (Revised), *Communication with Those Charged with Governance*, the auditor is required to discuss and communicate the basis of materiality with those charged with governance. This would help Those Charged with Governance (TCWG) understand the audit has been performed to what level of materiality. Also the materiality threshold should also be discussed with the audit committee and auditor should disclose the quantitative level of materiality applied to the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions, account balances or disclosures and the qualitative factors which were considered when setting the level of materiality.

The bottom line

On an overall basis, materiality is the crux of the audit since the audit scoping and the nature, extent and timing of the audit procedures are significantly dependent on the materiality determined for the financial statements. It may be worthwhile, from the users of financial statements perspective, for audit reports to include reporting around materiality considered by the auditor during the audit, to enable the users of financial statements to take more informed decisions.