Understanding materiality from the audit committee and auditors' lens

Board Leadership Center (India)

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Materiality is a fundamental concept in accounting and auditing that refers to the significance or relevance of an amount, transaction, or discrepancy. Materiality helps accountants and auditors to decide what information should be disclosed in the financial statements, and what level of assurance should be provided on the financial information.

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'.

Materiality is important for financial reporting because it ensures that the users of the financial statements receive reliable and relevant information that can influence their economic decisions. Materiality also helps to avoid cluttering the financial statements with immaterial information that may obscure the true and fair view of the financial position and performance of an entity.

Accountants and auditors should apply materiality at different stages of the financial reporting process, such as planning, performing, evaluation of misstatements, and disclosing information in the financial statements and annual reports. Materiality is a relative and subjective concept as it may vary for different items or classes of transactions within the financial statements and what may be material for one entity or user may not be material for another.

Interaction between auditors and audit committee on materiality

The audit committee and the auditors have different but complementary roles and responsibilities in relation to materiality. The audit committee oversees the financial reporting process and the quality and integrity of the financial statements and monitors the effectiveness of the external audit and the relationship with the auditors. However, the auditors are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. The auditors also communicate with the audit committee about significant matters arising from the audit, including the materiality judgments and decisions.

The communication and reporting of materiality between the audit committee and the auditors aims to achieve various objectives such as it would enhance the understanding and alignment of the expectations and perspectives of both parties on the concept and application of materiality, to facilitate the oversight and monitoring of the financial reporting and audit processes, and to ensure the transparency and accountability of the materiality judgments and decisions that affect the quality and integrity of the financial statements and the audit opinion.

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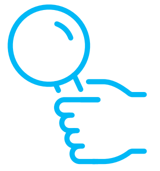
Factors that affect materiality



One of the challenges of applying materiality is that it involves both quantitative and qualitative aspects. Materiality is a general and pervasive concept in accounting, a purely numeric or quantitative approach to materiality does not work and there is no single or universal formula or threshold for determining materiality. Materiality depends on the context and circumstances of each entity and each reporting period. Therefore, it is important to apply professional judgement for materiality determination and consideration of both quantitative and qualitative factors.

A purely numeric or quantitative approach to materiality does not work and may lead to misleading or incomplete financial statements. There are certain situations or qualitative considerations which are to be considered irrespective of materiality. These exceptions usually arise from specific accounting standards, legal requirements, or ethical obligations. Following are examples of such situations which should be considered irrespective of materiality thresholds:

Related party transactions (RPTs)

RPTs can pose significant risks to the reporting entity and its stakeholders if they are not properly disclosed and monitored. RPTs are crucial area, and they should be disclosed in the financial statements regardless of their materiality because they could affect the assessment of the entity's financial position and performance, as well as its risks and opportunities. Additionally, while disclosing RPTs the entity should consider guidance under applicable accounting standards, laws, regulations, and best practices, and provide sufficient and relevant information to enable the stakeholders to assess the nature, extent, and impact of the transactions.

Fraud

Frauds must be corrected and reported as soon as they are detected, regardless of their materiality, because they could undermine the confidence and trust of the users of the financial statements, as well as expose the entity to legal or regulatory actions or sanctions.

Contingent liabilities

Contingent liabilities must be recognised in the financial statements if they are probable and can be measured reliably, or disclosed in the notes if they are possible but not probable or measurable. Contingent liabilities must not be ignored or omitted, as they could have a significant impact on the entity's financial position and performance in the future.

Non-compliance with laws or regulations

Such events must be disclosed unless they are clearly trivial, as they may expose the entity to legal or regulatory actions or sanctions.

Whistleblower complaints

All complaints should be evaluated beyond a consideration of purely quantitative materiality thresholds.

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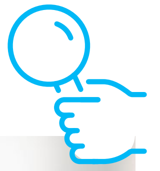


Industry-specific nuances

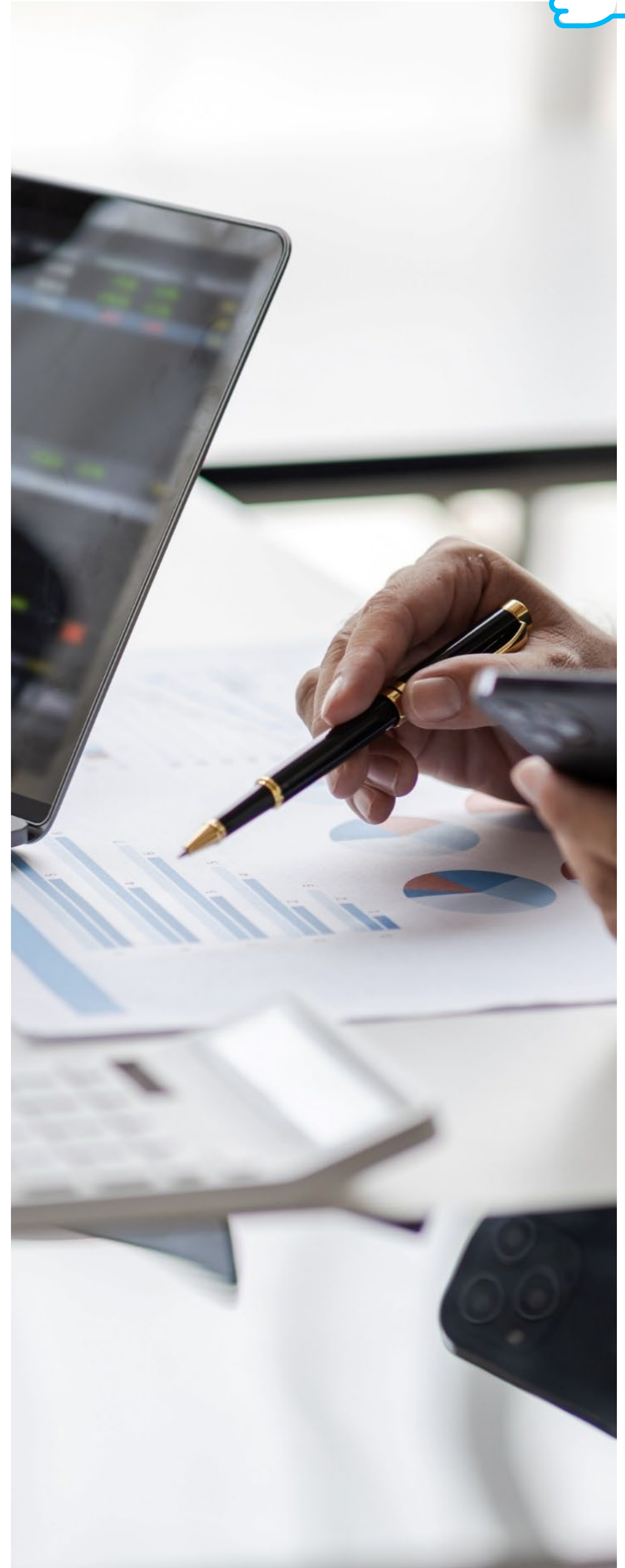
There are certain industries which are highly regulated, complex, and competitive and therefore, may have certain nuances which are unique or distinctive. Such nuances may affect the financial reporting and audit process and/or the audit opinion. Some of the examples of industry specific nuances are:

- In banking and financial services sector, the users of financial statements are mainly interested in the credit risk, liquidity risk, and capital adequacy of such institutions. Also, regulatory requirements and expectations of customers are critical areas for the sector.
- The research and development activities, pipeline and portfolio of products are some of the critical areas for pharmaceuticals sector. Therefore, the disclosure of research and development expenses, impairment of intangible assets, and contingent liabilities are some of the critical topics for the sector.
- For manufacturing sector materiality nuances related to the recognition, measurement, and disclosure of inventory, cost of goods sold, or environmental liabilities are critical.

Audit committees and auditors need to be aware of the materiality exceptions and industry-specific nuances that may affect audit engagements and financial reporting. As in such scenarios, additional considerations should be considered along with materiality guidance due to the unique characteristics or practices of the industry or the sector. Such scenarios may require application of more professional skepticism, judgment, expertise, or to use specialised techniques, tools, or resources.

Non-recurring or unusual items

Transactions or events that are non-recurring, unusual, or outside the normal course of business may have a greater materiality due to their nature, frequency, or unpredictability. For example, impairment, litigation settlements, or discontinued operations may have a significant impact on the financial statements.



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Key suggestions relating to materiality assessment

Audit committees could request the board and management to form a specific committee to oversee the determination and supervision of materiality. The committee could comprise of the Chief Financial Officer (CFO), Chief Executive Officer (CEOs), and Company Secretaries to facilitate a thorough comprehension and uniform implementation of materiality concept across the organisation.

The board and audit committees should seek to implement formal documentation process. Implementing a formal documentation process for materiality application can bring several benefits such as:

- Enhancing the quality and credibility of the financial reporting and auditing process
- Improving the communication and coordination among the board, audit committees, management, and external auditors by providing a common framework
- Facilitating the oversight and monitoring role of the board and audit committees
- Reducing the risk of disputes and litigation, as board will be able to demonstrate the rationale for the materiality judgments made
- Serves as a valuable source of feedback and guidance on how to improve the materiality judgments and the documentation process.

Ensure that financial information is consistent and accurate across different platforms when reporting and disclosing to different agencies or regulators. This can be challenging due to differences in materiality thresholds, reporting formats and deadlines. To address these challenges, it is recommended to have a clear and consistent materiality policy and process that defines the materiality level and criteria for each reporting or disclosure. Further, such policy and process should be documented and communicated across the organisation. Additionally, entities should implement a comprehensive and accurate reporting or disclosure system that captures, records, and reports all relevant information.

Further, audit committees should regularly monitor and assess the materiality process and communicate with management and external auditors about any changes or issues that may impact materiality evaluations. They should have a constructive and proactive dialogue with management and external auditors about the materiality judgments and estimates that may not be appropriate or consistent.

Materiality is a key concept in auditing that affects the quality and reliability of the financial information that is presented to the users. Materiality can also change over time, as the economic and business environment evolves. Therefore, it is essential to establish a mutual understanding and agreement between auditors and the company on the materiality level and the materiality threshold for the audit, and to communicate and document them clearly and timely.

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Conclusion

Materiality is a complex and dynamic concept that requires careful and continuous attention from audit committees and auditors. Both the audit committee and auditors have unique yet complementary responsibilities regarding materiality, and it is important to have a common understanding of how it is applied and communicated in financial reporting and auditing. By understanding and applying the principles, audit committees can enhance their oversight of the financial reporting and external audit processes and leading to more reliable and accurate financial information to the users and the public.

We would like to thank our Audit Committee Council Members for their time in providing us with their valuable insights and perspectives that have contributed to building this point of view document.

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