ICAEW AUDIT & ASSURANCE FACULTY

Materiality in assuring narrative reporting

THE JOURNEY: MILESTONE 4

ICAEW AND ASSURANCE SERVICES

All types of business, public and voluntary bodies, investors, governments, tax authorities, market regulators and their stakeholders need to be able to rely on credible information flows to make decisions. Confidence suffers when there is uncertainty about the integrity of information or its fitness for purpose.

ICAEW's Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance.

The re: Assurance thought leadership programme aims to –

- Find out where assurance services could strengthen markets and support economic confidence by making information flows more credible.
- Ask how the International Framework for Assurance Engagements can be applied and developed.
- Answer demands for practical guidance to meet emerging market needs.
- Share best practice examples and promote the high-quality assurance engagements already carried out by many ICAEW members.

WHAT ARE ASSURANCE SERVICES?

Assurance services are engagements in which an independent chartered accountant takes a close look at some specified business information, comparing it to agreed criteria.

The accountant is then able to gather evidence to support a conclusion, which is provided in a written report.

The purpose of any assurance engagement is to build trust. When a chartered accountant signs an assurance report, they attach their reputation for expert knowledge and integrity.

This makes the business information covered by the report more credible, and gives confidence to the people using that information.

To learn more about what assurance can do, take a look at the articles, guidance and reports on icaew.com/assurance or telephone Ruth Ward on +44 (0)20 7920 8639.

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Introduction

The journey towards assurance over a wider range of business information will only take place if that information is seen as valuable by the people that rely on it. Assurance is meaningful when it adds necessary confidence, for example by reducing risk for investors who can take comfort that the information on which they are making decisions is reliable. In *'The Journey: Assuring All of the Annual Report?'* we discussed the range of possibilities for assuring part or all of the annual report.

We are now turning our attention to a basic issue that is relevant to all assurance engagements – materiality.

In the context of financial statements it is generally accepted that: '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.'[1] This definition can also be used for narrative reporting, with the substitution of 'narrative assertions' for 'financial statements'.

However, in financial accounting, a monetary value can be set representing a materiality level such that the risk of a material misstatement can be reduced to a low level. In an assurance engagement the objective is the same: the desire to reduce the risk of a material misstatement of the subject matter to a low level in a reasonable assurance engagement. The questions that his Milestone seeks to answer are:

- How can that be achieved; and
- Once established, how should the practitioner use materiality when assuring the report?

For the avoidance of doubt we are assuming that the users of the narrative report are the shareholders and potential investors.

As the concept of materiality involves considerations by a practitioner of what could reasonably be expected to influence other person's decisions, it is clear that a high level of professional judgment is necessary in reaching a conclusion and that there can never be a definitively correct answer. Practitioners should document in writing their reasons for arriving at a particular conclusion.

How does the preparer decide what is material?

The preparer of non-financial information is the first to have to consider materiality. Materiality is the final test of what information should be included and to what degree of accuracy. It is determined, by the preparer, with reference to their understanding of the investors' needs, achieved during and through the management process used to develop the report content. Investors can be questioned on their interests, priorities and sensitivity to error and this provides the base information for determining materiality.

Similarly to preparing financial information the preparer may think through the investors' needs in terms of the following and use this thought process to develop guidelines which can then be shared with the practitioner.

- What types of information are likely to influence the decisions of the users?
- For any given matter, what is the appropriate context for assessing its materiality?
- When do non-financial issues become qualitatively critical in terms of materiality? For example, are there qualitative thresholds (such as the difference between 'an area for improvement', or a 'significant deficiency') at which regulatory action kicks in?
- How should particular items in these critical areas be decided and reported?

1 ISA (UK and Ireland) 320 para 2.

How does the practitioner decide what is material?

The main elements of the practitioner's work when assuring a narrative report need to be understood in order for materiality to be explained in context.

Establishing the report content

- Understanding the management process used to develop and define the report content;
- evaluating the controls over and operation of the process, including the culture of the organisation; and
- evaluating the output from the process ie, the report content.

The first and second of these bullet points are particularly important in the context of narrative assertions. Most companies will have internal systems in place that will help to ensure the accuracy of financial information. However, when it comes to prospective assertions or statements as to social policies and similar matters, controls may be less effective. In such a case, assurance providers may need to extend the scope of their work.

Assuring the report content

- Identifying what within the narrative needs assuring; and
- establishing suitable measures to support tests used to evaluate the content.

In this paper we are focusing on how the practitioner determines and uses materiality in the context of the established report content.

Additional procedures could include co-operation with industry experts and other specialists. Other procedures, including consideration of the narrative disclosures made in the reports of similar companies, consideration of any changes made in the scope or nature of the disclosures in the report, and the use of professional judgment to satisfy the practitioner that those matters relevant to an understanding of the business have been disclosed to an appropriate level could be carried out.

The following assumes that within the overall process an appropriate level of information has been obtained in order to enable materiality levels to be established.

Claims and significant claims

The narrative will contain many claims, both qualitative and quantitative in nature. Based on their understanding of the purpose of the report and the use to which investors will put it practitioners need to read and identify those claims on which they might reasonably expect investors to rely. Once these have been identified, they can reduce to a low level the risk of a misstatement in the report impacting the investors' bases for decision making. Therefore, the practitioner's work focuses on significant claims.

Assertions

For each significant claim the practitioner needs to establish the key assertions; just like a financial statement audit. For quantitative claims the assertions can be defined as: completeness, existence, accuracy, ownership, and presentation. Their definitions are very similar to those for an audit of financial statements due to their numerical nature.

For qualitative claims the assertions are different, being typically:

- **completeness:** all material events related to a topic have been included or addressed;
- **occurrence and accuracy:** the way events and circumstances have been described is accurate and contains no significant omissions; and
- **presentation and understandability:** the way the events have been described is appropriate and balanced, is unbiased and transparent.

How the practitioner uses materiality

The practitioner uses materiality throughout the engagement.

Planning and engagement strategy

For each significant claim of the subject matter that the practitioner is reporting on within an assurance engagement, he determines a:

- **materiality threshold:** if the subject matter is quantitative; or
- **materiality factors:** if the subject matter is qualitative.

Materiality thresholds are used for quantitative (numeric) subject matters. In determining materiality thresholds, we consider:

- **the needs of intended users:** ie, the threshold above which a misstatement, including omissions, would individually or in the aggregate, reasonably be expected to influence the decisions of the intended users; and
- **the criteria:** some criteria may set out what would be considered material.

Materiality thresholds are used as a basis for identifying the risks of material misstatements and determining the nature, timing and extent of testing.

Materiality factors are used for qualitative statements and are set out below:

Narrative factors that could lead to a material misstatement

In each of the following circumstances the practitioner needs to obtain sufficient evidence so as to be able to reach a reasonable opinion as to whether a user of the report might have been materially misled:

- **Omission of facts:** could the omission of significant facts relevant to a claim result in a misleading position being represented?

Example: reports that demonstrate weaknesses or failings in the business performance or plans have been ignored and not referred to in the narrative.

- **Misstatement of facts:** could the misstatement of significant facts relevant to a claim result in a misleading position being represented?

Example, a retail clothing company may claim to have implemented an ethical supply chain policy and a related monitoring mechanism. However, if it has failed to include in its report all the differences and divergence from policy identified during monitoring visits to suppliers then we need to consider whether that represents a misstatement.

In forming a view we would need to consider the nature of the items omitted and evaluate whether together they represented a misstatement of the facts relating to the state of compliance across the supply chain. In forming this evaluation professional judgement would need to be applied in relation to the relative significance of state of compliance to the investors and the extent to which the actual state was misrepresented by the missing facts.

- **Misrepresentation of trends:** are management making claims that do not represent the facts available?

Example, 'Over the last three years we are the most improved retailer in the sector for energy efficiency'. It may be impossible to evaluate the validity of this claim due to a lack of third party data and inconsistencies/different bases used by each retailer in the sector. However, should there be an independent and credible third party survey that provides an objective analysis, then it may be possible for management to say that, 'According to the ABC survey, over the last three years we are the most improved energy user in the sector'.

- **Bias in description of position or facts:** are management focusing reporting on the positive and excluding negative matters?

Example, a management report may focus on two or three case studies that demonstrate good work but make no comment on weaknesses in policy or its lack of application in important related areas that would damage or diminish the message in the case studies.

- **Unsubstantiated claims:** are management making claims that would be regarded as important to and be relied upon by users, but that are not substantiated by facts?

Example, 'We are the leading ethical bank in the retail banking sector'. If there is no independent evidence to support such a statement, but it is regarded as being a significant claim, then management should be required to provide the evidence or revise the claim to something that is supportable.[2]

A summary of the five factors above is that the narrative report should be fair, balanced and understandable. Omission of facts or bias would be neither fair nor balanced. Misstated or unsubstantiated claims would not be fair. Misrepresentations might be neither fair nor balanced and might be designed to be misunderstood.

Established practice and guidance

The practitioner should also ensure that any established practices and guidance in defined areas have been applied, eg, the requirements for reporting on business strategy may have been defined in reporting guidance. Where there is specific guidance as to materiality, as for Greenhouse Gas Emissions, these should be used.[3]

When providing assurance on a process, the established practice of breaking down the process into control objectives is critical. It allows management and the practitioner to assess the significance of observed deficiencies in design and operating effectiveness of controls within the process, by considering the effect of such deficiencies on the achievement of any individual control objective. That allows management and the practitioner to take into account compensating controls and the tolerable level of deviation given the population of transactions passing through the process. Assessing the materiality of a control deficiency by attempting to extrapolate a total value of the error using the value of actual instance of control failure detected is unlikely to be effective.[4]

2 It should be noted that, throughout, we are only looking at significant claims – that is those claims on which it is reasonable to suppose stakeholders will rely upon.

3 ISAE 3410 paragraphs A44-A51.

4 ISAE 3402: A16-A18 is helpful here and can be adapted to reports over processes in contexts other than that of outsourced service organisations.

Testing

Once materiality has been set, in conjunction with the analysis of engagement risks, the practitioner can determine:

- what to test and how large any samples might need to be; and
- what will constitute an error during testing.

When tests are performed any errors or differences need to be captured and measured against the materiality factors to determine:

- whether to extend the testing to clarify the extent of the error; and
- how significant the difference (or divergence) might be.

The principles of what to do next are the same as for an audit but it is harder to make the case for offsetting identified errors in non-financial reporting. There is no reason why material exaggeration of one positive characteristic of non-financial subject matter would be seen 'cancelling out' material exaggeration of a different negative characteristic. However, it remains important to collate errors and consider them collectively, so that the practitioner can consider whether the errors are indicators of a pattern of bias in the preparation of the information or some other form of misrepresentation at a higher level across the management report.

Reporting

When reporting, the same principles apply as for an audit. Management should be encouraged to address or correct as many of the errors and differences as is appropriate. The nature and extent of any unadjusted differences is then considered in the context of the report and materiality.

Depending upon the practitioner's evaluation decisions will be made regarding whether or not to:

- report any of the remaining uncorrected matters to the users;
- report any of the remaining matters to the users in the practitioner's report by way of clarification; and
- modify the practitioner's report in any respect to reflect any of the errors.

Discussion Points

What's your view? Have you had to establish materiality over narrative reporting? If so, how did you go about determining materiality? What alternative bases have you used to determine materiality and then apply it to narrative?
Please share your views with us by email or on twitter.
Henry.Irving@icaew.com
@haicaew

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ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

T +44 (0)20 7920 8450
E tdaf@icaew.com
icaew.com/assurance

linkedin.com – find ICAEW
twitter.com/ICAEW
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