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INTERNATIONAL ACCOUNTING, AUDITING AND ETHICS
AUDIT AND ASSURANCE FACULTY

Materiality in the audit of financial statements

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If you would like to comment on this publication or find out more about the issues raised, contact Louise Sharp at louise.sharp@icaew.com.

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1. Introduction

This publication is a practical guide for auditors who are applying the materiality requirements in International Standards on Auditing (ISAs) on audits.

The guide takes a look at the ISA requirements, highlighting key challenges and common pitfalls and providing practical illustrations intended to be relevant to all jurisdictions where ISAs are applied. It does not, however, address any specific local requirements that jurisdictions might have in place in this area and where this is the case, auditors should read this guide in conjunction with these local requirements.

The guide is intended to be of particular help to smaller firms, including sole practitioners and those firms with a few audit engagement partners, but is relevant to firms of all sizes.

ICAEW's international objectives and discussions with professional bodies outside the UK prompted us to issue an international guide in this area. As noted in global inspection findings and reviews in this area – and from experience in practice – it is clear that addressing the materiality requirements in ISAs presents real practical challenges for audit firms of all sizes and is an area where improvement could be made.

We hope that the guide will help firms to better understand and appropriately apply the materiality requirements in ISAs on their audits. Reading this guidance is not, however, a substitute for reading the ISAs.

This guide draws on the extensive knowledge of, and has been put together by, a working group of experienced auditors.

ICAEW has already issued international versions of guidance on the audit of groups, quality control and related parties. We hope that this guidance will prove helpful to auditors in different jurisdictions.

2. What is materiality and why is it important?

ISA REQUIREMENTS

ISA 200 *Overall objectives of the independent audit and the conduct of an audit in accordance with International Standards on Auditing* clarifies that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements (ISA 200.3). This is achieved by the auditor giving an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. As the basis for the auditor's opinion, ISAs therefore require auditors to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

ISA 200.6 explains that in general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in the light of surrounding circumstances. They are affected by auditors' perceptions of the financial information needs of users of the financial statements, and by the size or nature (or both) of a misstatement.

The concept of materiality is therefore fundamental to the audit. It is applied by auditors at the planning stage, and when performing the audit and evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. While materiality is first determined at the planning stage, auditors need to be mindful that circumstances may change during the audit or some of the audit findings may mean that the initial assessments have to be reassessed.

DEFINITION

The ISAs are set out methodically with the following sections:

- introduction
- objective
- definition
- requirements
- application and other explanatory material.

However, ISA 320 *Materiality in planning and performing an audit* does not include a definition for materiality. Perhaps the most important reason why materiality is not defined in the ISA is because the principle of materiality is first and foremost a financial reporting, rather than an auditing, concept. Also, the interpretation may differ in different parts of the world.

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. It is important therefore that auditors refer to any discussion of materiality in the financial reporting framework when determining materiality for the audit. Such a discussion, if present, provides auditors with a frame of reference.

The ISA does, however, highlight some key words and phrases in relation to materiality in the context of an audit which include:

- misstatements (including omissions) which could influence decisions of users of the financial statements;
- judgement (ie, there is not a single right answer) based on surrounding circumstances including the size and nature of the misstatement; and
- that those decisions are based on the users' common needs as a group.

Given these characteristics, to condense materiality into a single figure (albeit sometimes supplemented with lower levels for individual balances, classes of transactions and disclosures) may seem impossible. However, the standard requires it and there are good reasons in practice to do so.

The diagram below summarises the ISA requirements on materiality that are covered in this guide:

DETERMINE OVERALL MATERIALITY	ACCUMULATE MISSTATEMENTS
DETERMINE PERFORMANCE MATERIALITY	EVALUATE MISSTATEMENTS, BASED ON SIZE AND NATURE
DETERMINE LOWER SPECIFIC MATERIALITY	REASSESS OVERALL MATERIALITY
DETERMINE CLEARLY TRIVIAL THRESHOLD	COMMUNICATE WITH THOSE CHARGED WITH GOVERNANCE
GROUP AUDITS: DETERMINE COMPONENT MATERIALITY	

DOCUMENT:

- MATERIALITY;
- EVALUATION OF MISSTATEMENTS; AND
- RATIONALE FOR BOTH.

These are picked up in this guide under five key themes:

- Determining materiality
- Applying materiality to the evaluation of identified misstatements
- Materiality in group audits
- Communications with management and those charged with governance
- Documentation.

3. Determining materiality

This section looks at how both overall materiality and performance materiality are determined.

DETERMINING OVERALL MATERIALITY

Auditors set the materiality for the financial statements as a whole (referred to in this guide as 'overall materiality') at the planning stage.

The primary purpose for setting overall materiality when planning the audit is that it is used to identify performance materiality (which is needed, for example, to help auditors design their audit procedures) and a clearly trivial threshold for accumulating misstatements.

While the approach is not mandated, typically there are three key steps:

- choosing the appropriate benchmark;
- determining a level (usually a percentage) of this benchmark; and
- justifying the choices (ie, explaining the judgement).

There are, however, other practical challenges to think about here such as:

- whether to set a specific level of materiality for individual balances, classes of transactions or disclosures; and
- short and long periods of account.

Choosing a benchmark

ISA 320.A4 includes a number of factors to consider when choosing a benchmark. These include the nature of the entity and the industry in which it operates and whether users focus on particular items in the financial statements. Also important is the relative volatility of the benchmark, so some reference to previous periods is common.

The appropriate benchmark chosen should therefore link to what the users are most concerned about in the financial statements.

Appropriate benchmarks

ISA 320 gives a number of examples of benchmarks that can be used. These include:

- profit before tax or normalised (or adjusted) profit before tax
- total income or total expenses
- gross profit
- total equity
- net assets.

In a commercial owner-managed company, profit before tax may be the starting point. However, there are a number of reasons (for example, the volatility of this benchmark) why a different benchmark may be deemed more appropriate.

Though not cited as an example in the ISA, gross assets (as well as net assets) might be appropriate for an entity with significantly higher values in the balance sheet compared to its income statement (such as an investment property entity). For an occupational pension scheme, materiality may typically be based on a percentage of the total value of the scheme assets or the inflows/outflows from dealing with members.

Though not common, there are instances where total expenditure is more appropriate than total income. For example, a charity's level of income may vary from one year to the next but the expenditure may be more consistent.

Net assets might be an appropriate benchmark to use for a start-up company which has little revenue or profits. Also EBITDA (earnings before interest, taxation, depreciation and amortisation) may be relevant for companies with substantial financing costs.

The truth is one size does not fit all. Auditors need to use their professional judgement to determine an appropriate benchmark and the chosen benchmark needs to be justifiable, with the rationale clearly documented.

The potential problem with profit
It is understandable that profit is deemed an important benchmark in a profit-making business (there's a clue in the term used). However, this can raise a number of questions:

- What if the profits are very volatile from one year to the next?
- What if the entity is owner-managed and most of the profit in the year is distributed by means of remuneration to the directors/shareholders or a payment into the pension scheme?
- What if the entity has made a loss in the year?
- What if the entity has broken even in the year?

It doesn't seem unreasonable to argue that an item that turns a profit into a loss or vice versa must be material. But if that is taken to its logical conclusion, sooner or later auditors of a multi-billion pound business are going to be faced with a very low materiality.

Some of the problems above are solved by looking at the 'normalised', or what is more commonly referred to as 'adjusted', profit where auditors would add back exceptional items.

This raises the question of what type of adjustments are appropriate and in what circumstances they are appropriate. The answer lies in determining what it is that the users of the financial statements are really focusing on.

Clearly it seems reasonable to include items that are defined as exceptional in the accounting framework because users generally focus on the underlying performance of the business. But often auditors will also add back things like the remuneration paid to owner managers (ISA 320.A9 suggests as much).

It is also possible to use an average of the benchmark (eg, the average adjusted profit before tax over 3–5 years) which can smooth out the volatility. Of course, it is always a matter of professional judgement and auditors need to be clear why they have chosen a particular route. For example, if there has been a step change in the business, it would be dubious to take an averaging approach simply because it helped to deliver a figure that auditors wanted.

Nonetheless, where materiality would differ widely even though the scale of the business is largely the same, sometimes auditors simply have to accept that adjusted profit may not be appropriate and a different benchmark, such as total revenue (see example in this section), is needed.

The use of multiple benchmarks
In the past it was not uncommon (not least because this was encouraged by more than one methodology provider) to see firms determining materiality as an average of two, three or four different benchmarks.

This is less prevalent now, in large part because there is no mention of taking averages in ISA 320. That said, the same fact means there is also nothing in the ISA to say it is inappropriate. An argument against taking an average, however, would be that auditors are taking neither one thing nor the other eg, if the auditors believe that users will focus on, say, profit, turnover and net assets, then using a materiality based on an average for these three benchmarks is likely to lead to an amount which seems uncomfortably large for at least one of them. Also, while there is typically the option of a judgement override there is a tendency to accept the result, removing the all-important thinking (ie, professional judgement).

More common in current practice for such a situation would be to look at other benchmarks when deciding the percentage to be applied. The example in this section reflects this.

Determining the level of the benchmark
There is almost nothing in the ISA about this but the emphasis is on professional judgement. The two examples of applying a percentage to a benchmark in ISA 320.A8 are for a profit-oriented manufacturing business (5% of profit before tax from continuing operations) and a not-for-profit entity (1% of total income or expenses). It does stress that higher or lower percentages may be appropriate.

For guidance here, it is useful to look at methodologies used by small and medium-sized audit firms (although these methodologies wisely tend to steer clear of being too prescriptive) as well as examples included in reviews by regulators, for example the UK Financial Reporting Council (FRC) Audit Quality Thematic Review on materiality (2013). Two things immediately become apparent:

- auditors tend to use a range of levels for each benchmark; and
- the ranges used are similar.

Another feature highlighted by the FRC thematic review is that the larger firms tend to use different ranges for listed and non-listed entities. This is reasonable as the stakeholders are often different and they may well have different priorities on which they base their economic decisions.

Typically firms and networks issue guidance that says ‘up to X%’ or ‘Y% or less’ to highlight the fact that benchmark levels will vary according to the circumstances and that this requires judgement. Nonetheless a regular criticism from regulators is that they see auditors take the ‘unthinking’ approach of always using the top end of the range.

Specific levels of materiality for individual balances, classes of transactions or disclosures
Sometimes a specific balance, class of transaction or disclosure in the financial statements warrants a lower level of materiality because users could reasonably be expected to be influenced by a smaller change to the reported figure. ISA 320.A11 suggests the following are factors to consider:

- whether laws and regulations affect users’ expectations (eg, related party transactions with and the remuneration of directors/trustees);
- key disclosures in relation to the industry (eg, research and development costs in a pharmaceutical entity); or
- whether attention is focused on a particular aspect of the business that is separately disclosed (eg, disclosures about segments or a significant business combination).

The most common situation where this occurs is with transactions with individuals that are related parties and the example later in this section reflects this situation.

Sometimes one figure for materiality doesn’t seem to be enough, even though ISA 320 requires a single overall materiality and being able to set a lower specific level of materiality for individual balances, classes of transactions or disclosures might help here.

The total value of investments in an occupational pension scheme is £1m but the total contributions receivable from active members is only £250,000. Clearly, applying any sensible percentage to the former is going to dwarf the whole of the income statement and other balances (such as debtors).

The solution is to determine an overall materiality based on the total value of investments and then set lower specific materiality for the contributions receivable, contributions payable, other expenses, debtors and creditors.

Short/long periods of account and impact on benchmark and materiality
A problem can arise when auditing the financial statements of a period that is more or less than one year. ISA 320.A7 confirms that materiality should relate to the financial statements being prepared for that financial reporting period.

Ordinarily, the balance sheet will not vary widely from one month to the next so there is no issue if the chosen benchmark is, say, total assets. However, what if the chosen benchmark has previously been, say, revenue and now the entity is preparing financial statements for a six-month period? Potentially the materiality will be half that of previous periods. In one respect this is sensible as the numbers in the income statement will only be half as large. But potentially the materiality on the balance sheet balances (that are broadly equivalent to previous years) will be too low. The problem is flipped if the accounting period is, say, 18 months.

The answer, as ever, involves judgement but will often entail re-evaluating whether the benchmark usually chosen is appropriate for this period and whether the percentage of the benchmark needs to be altered.

Justifying the decisions
It's often said that, regardless of a firm's policies and procedures, experienced auditors will have a good instinct as to what is and isn't going to affect decisions made by users of the financial statements (and therefore what materiality actually is). It is good that the standards do not box auditors into something that may not make sense.

The key, however, is to reflect this experience and the thought process on the file. Poor documentation (including on materiality) is one of the most common criticisms of regulators.

EXAMPLE: TOTAL REVENUE

Determining overall materiality

Example	Current year (20XZ) (£'000)	(20XY) (£'000)	(20XX) (£'000)
Revenue	13,573	12,708	12,210
Profit before tax	161	103	424
Exceptional payment into the occupational pension scheme	–	200	–
Adjusted profit before tax	161	303	424
1.5% of revenue	204	191	183
Assessed materiality on the financial statements as a whole	140	190	180
In previous years we have determined an appropriate level of materiality to be 1.5% of revenue. However, the current year's rise in revenue (due to specific exceptional orders) is not expected to be repeated in future years. This, plus the overall drop in adjusted profit before tax, leads us to conclude that a more appropriate basis for materiality this year would be 1% of revenue.			

DETERMINING PERFORMANCE MATERIALITY

ISA 320.9 defines performance materiality as the amount(s) set by auditors at below overall materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall materiality.

In simple terms, performance materiality is the 'working materiality'. It sets a numerical level which helps guide auditors to do enough work (but, importantly, not too much) to support their audit opinion. It recognises that if auditors simply applied the overall materiality throughout the planning and fieldwork stages they would be taking an undue risk that material misstatements were not detected by their audit work.

Broadly it serves two functions:

- to reduce the aggregation risk (the risk that the aggregate of uncorrected and undetected misstatements individually below materiality will exceed materiality for the financial statements as a whole) to an acceptable level; and
- to provide a safety net against the risk of undetected misstatements.

Setting performance materiality
The key word therefore is 'risk'. Having set overall materiality, performance materiality is a lower figure. How much lower will depend on, for example, the assessed level of risk of material misstatement (ISA 320.A13).

Take two entities in the same industry with similar levels of revenue and assets. The shareholders, potential shareholders, employees and customers (ie, users of the financial statements) are also similar. If all things are equal then overall materiality (however determined) ought to be similar.

However, based on knowledge and experience of the first entity the auditors do not anticipate any adjustments will be needed as there is a very strong control environment and management consistently applies effective control procedures. By contrast the second entity has a weak control environment and the auditors anticipate they will identify numerous areas requiring adjustment. While overall materiality will be similar, clearly the risk in the second entity is greater and performance materiality should therefore be lower.

Usually audit methodologies require performance materiality to be a percentage of overall materiality (or variations amounting to much the same thing). The higher the assessed risk, the lower the percentage. Typically the percentages range from 75% (low risk) to 50% (high risk).

Using performance materiality in practice
Broadly, performance materiality is used at two stages of the audit:

- early in the planning stage, to help to identify what areas need to be audited and how much and what type of work is needed; and
- during the early fieldwork stage (arguably still part of the planning) in identifying more precisely which items need to be tested including sampling and how many items to include in the sample.

To illustrate the first point above, if overall materiality is £140,000 and performance materiality has been set at £105,000, the response to a simple balance such as the prepayments figure (where the key audit assertion is existence) could vary as follows.

Value of prepayments (£'000)	Planned approach
90	Do nothing as there is no risk of material misstatement.
120	Although the figure is not material, because it is more than performance materiality, auditors may need to do something. It is likely that they would carry out analytical procedures based on expected prepayments.
250	As this is considerably more than performance materiality, more evidence is needed to be deemed sufficient. For example, auditors may decide to test a sample of individual transactions.

Auditors may confuse performance materiality with tolerable misstatement. Tolerable misstatement is referred to in ISA 530 *Audit sampling* and is an example of performance materiality when applied to the selection and evaluation of results when sampling. However, performance materiality is also used for other things at the planning stage. It is also a reference point when evaluating the results of other (non-sampling) substantive analytical procedures.

Specific materiality and higher-risk balances, classes of transactions and disclosures
If lower materiality has been set for specific balances, classes of transactions or disclosures auditors will need to apply a lower performance materiality here as well.

EXAMPLE: TOTAL REVENUE CONTINUED

Continuing the previous example on determining overall materiality:

Determining performance materiality

Example	Current year (20XZ) (£'000)	(20XY) (£'000)	(20XX) (£'000)
Performance materiality	90	140	135
This assignment has been assessed as medium risk this year (due to changes in personnel involved in the accounting function) and therefore we have determined performance materiality at 65% of overall materiality in line with our network's guidance.			
Lower specific materiality for specific balances, classes of transactions and disclosures		**Materiality (£'000)**	**Performance materiality (£'000)**
Transactions with individuals who are related parties		5	4
These transactions are more sensitive to small changes.			
Clearly trivial			
The level below which misstatements are deemed to be trivial has been set at 5% of overall materiality. Therefore it is £7,000. NB. Misstatements may not be trivial because of the nature of the misstatement even if they are less than this figure.			

Reassessing materiality during the audit
Auditors may need to revise overall materiality during the audit if they become aware of information during the audit that would have caused them to determine a different amount initially. This can arise in practice where overall materiality is determined prior to the entity's year end based on forecast information (eg, the entity's forecast profit before tax), and the actual figure differs significantly from the forecast, perhaps because of an unplanned disposal of a part of the business or a material audit adjustment being identified.

If the auditors conclude that a lower overall materiality is appropriate (and, if applicable, materiality levels for particular classes of transactions, account balances or disclosures), they also consider whether it is necessary to revise performance materiality, and if so, they consider the impact on the nature, timing and extent of their audit procedures.

4. *Applying materiality to the evaluation of identified misstatements*

ISA 450 *Evaluation of misstatements identified during the audit* deals with auditors' responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. This section looks at the practical issues around:

- accumulating misstatements during the audit;
- categorising misstatements according to their nature;
- assessing the materiality of misstatements; and
- considering the impact of misstatements on the audit.

Evaluating identified misstatements requires auditors to apply professional judgement. It is important to consider both the size and the nature of the misstatements identified, as a misstatement that might seem relatively small could still be material due to its nature.

ACCUMULATING MISSTATEMENTS DURING THE AUDIT

ISA 450.5 requires auditors to accumulate misstatements identified during the audit other than those that are clearly trivial. ISA 450.A3 explains that auditors 'may designate an amount below which misstatements of amounts in the individual statements would be clearly trivial, and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements'.

It is helpful to avoid the need to record small misstatements that may be found during the audit. Therefore, auditors often set a threshold for recording misstatements. This is referred to in this guide as a 'clearly trivial threshold'. In determining the amount of this threshold, auditors use professional judgement, taking into account their experience of the entity including, for example, the past history of misstatements detected during the audit and their assessment of audit risk. In practice, auditors generally consider an amount based on a range of up to 5% of overall materiality to be appropriate. The position within the range, or whether an amount beyond the range can be justified, depends on the auditors' judgement. For example, if there is a history of a large number of misstatements being identified, an amount near the bottom end of the range would be appropriate, to reduce the risk that small misstatements (that would not be recorded if the threshold was set too high) could aggregate to a level that ought to be reported to management and those charged with governance.

Misstatements below the threshold set by auditors need not be recorded on their summary of misstatements, unless they consider it appropriate to do so because the nature of the misstatement means that it is not clearly trivial (as shown in the example in **Section 3, Determining materiality**).

> There may be a number of small misstatements all affecting the same area such as inventory, indicating that there could be deficiencies in internal control in that area, and this information may be useful for management.

Sometimes, those charged with governance ask auditors to report all misstatements identified during the audit, irrespective of size, and in that case no threshold is used.

CATEGORISING MISSTATEMENTS

To help auditors evaluate the effect of misstatements and communicate misstatements to management and those charged with governance, ISA 450.A6 explains that it may be useful to distinguish between factual, judgemental and projected misstatements and defines these as follows:

Factual misstatements are misstatements about which there is no doubt.

Judgemental misstatements are differences arising from the judgements of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that auditors consider unreasonable or inappropriate.

Projected misstatements are auditors' best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530.

Factual misstatements

A factual misstatement includes, for example, a simple error in recording transactions.

> An invoice recorded in the accounting records at £5,000 instead of £15,000.

Judgemental misstatements

Judgemental misstatements arise in relation to accounting estimates. Estimates cannot be considered accurate with certainty, and therefore auditors generally develop a range of amounts for each estimate that would be considered reasonable. Management's estimate would normally be acceptable if it falls within this range. However, if the auditors believe that the entity's estimate is unreasonable, the difference between that estimate and the closest end of the auditors' range is considered to be a judgemental misstatement – the auditors' judgement has differed from management's judgement, perhaps in relation to a specific assumption such as a discount rate that has been used.

> The auditors may determine that an appropriate range for a provision for obsolete inventory is between £160,000 and £200,000. If the entity has recorded a provision of £140,000, the judgmental misstatement is £20,000 (ie, £160,000 - £140,000).

In some cases, while estimates may be considered individually reasonable, they could collectively indicate a possible bias on the part of the entity's management. Where this is the case, auditors make a qualitative assessment as to whether the financial statements are materially misstated.

Projected misstatements

Where misstatements are found as a result of audit sampling, auditors project the results of the sample to the population as a whole from which the sample was selected. This projected misstatement is then recorded on their summary of misstatements.

The auditors have designed a test for accounts receivable which involves two methods of selecting items for testing (based on ISA 500.A52):

1. selecting some specific items for testing (based on their size and/or risk); and
2. taking a sample of items from the remaining population.

Misstatements have been identified both in the specific items tested and in the sample. The misstatements in the sample have been projected to determine the potential misstatement in the population:

Total population: £5,000,000 (456 items)

1. Specific items selected prior to sampling: £890,000 (10 items). Misstatements identified by testing = £3,400 (this represents a factual misstatement and as no sampling has been involved here it is not appropriate to extrapolate these findings)
2. Sampling: value of items included in sample = £474,000. Misstatements in items sampled = £1,290

Projected misstatement = £9,895 [£1,290/£474,000 * (£5,000,000 – £890,000 – £474,000)]

For inclusion on summary of misstatements:

Factual misstatements = £3,400 + £1,290

Projected misstatements = £9,895

The auditors request entity management to correct any factual misstatement(s) found (ISA 450.8) and will have discussions with management regarding differences in judgement in order to agree whether an adjustment is needed. But it will be difficult to persuade management that financial statements should be 'corrected' for a projected misstatement as, given the sampling risk, there can be no certainty that the projected misstatement represents the true misstatement in the population. Where the projected misstatement, in combination with other identified misstatements, is below overall materiality, the auditors can still conclude that the financial statements are not materially misstated. But where overall materiality is exceeded, the auditors have a problem as the financial statements could be materially misstated. Auditors may also need to consider if, for example, the combination of the projected misstatement and other identified misstatements is below overall materiality but very close to it (given the increased risk of uncorrected misstatements and undetected misstatements exceeding materiality). In these cases, they have two options – either to request management to investigate the population (and then to check the results of management's work), or to perform sufficient additional testing directly in order to reduce the impact of any projected misstatement.

ASSESSING THE MATERIALITY OF MISSTATEMENTS

Having accumulated the various factual, judgemental and projected misstatements on the summary of misstatements, auditors determine whether uncorrected misstatements are material, individually or in aggregate, as required by ISA 450.11.

According to ISA 450.A16 'Each individual misstatement of an amount is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded'.

In assessing whether misstatements are material, the auditors need to consider both the size and the nature of those misstatements.

In terms of the size of misstatements, this means considering whether the quantitative amounts of those misstatements exceed overall materiality (or lower specific materiality). But that's not enough. It is not just a simple quantitative assessment of whether £X exceeds £Y. There are a number of issues that auditors may need to consider, including:

- qualitative assessment;
- balance sheet misclassifications;

- offsetting of misstatements;
- disclosure misstatements; and
- impact of uncorrected misstatements related to prior periods.

Qualitative assessment
The nature of some misstatements may cause auditors to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the overall materiality that they have determined for the financial statements as a whole. ISA 450.A21 provides some examples of these circumstances, such as a misstatement that relates to the incorrect application of an accounting policy that has an immaterial effect on the current period's financial statements, but is likely to have a material effect on future periods' financial statements. Other situations might include misstatements that would turn a profit into a loss if corrected, or which might trigger a default in a banking covenant.

As noted in ISA 450.A22, the auditing standard on the auditor's responsibilities in relation to fraud (ISA 240) explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements. Fraudulent financial reporting that results in misstatements caused by management is, by definition, almost always material (regardless of the size of the misstatements) because of management's intent to influence some action or decision. For example, if management has deliberately pushed sales near the year end into the next financial year, it may have done so in order to reduce the entity's tax liability.

It is important to remember that auditors may have determined lower specific levels of materiality for particular account balances, classes of transactions and disclosures. Misstatements in these areas need to be considered in the context of their specific materiality, rather than in relation to the overall materiality for the financial statements as a whole. Typically this might apply to areas such as related parties and disclosures of directors' remuneration – as such areas are usually particularly sensitive, and even if auditors did not formally determine a lower specific materiality, even relatively small misstatements in these areas will generally be considered material because of their nature.

Balance sheet misclassifications
Where auditors have used a profit-based measure to determine materiality, they consider whether misstatements that only affect balance sheet classifications are not material even if they exceed overall materiality, as explained in ISA 450.A20. It is important to consider all relevant factors, including the amount of the misstatement in relation to the size of the related balance sheet items and any potential impact on key performance indicators and financial ratios (including whether any ratios for banking covenants are affected). There may be circumstances where auditors conclude that a classification misstatement is not material in the context of the financial statements as a whole.

> A misclassification of an amount exceeding overall materiality between two asset lines on the balance sheet might not be considered material if the amounts involved were a small percentage of each line. But if those two lines were cash and accounts receivable, and the amount of cash was used in calculating a key balance sheet ratio, the amount would most likely be considered material (and where a key ratio is affected, it would likely be considered material even if below overall materiality).

Offsetting of misstatements
Auditors may face a situation where misstatements offset each other.

There may be misstatements which mean that both revenue and expenses are individually misstated by amounts exceeding overall materiality, but the net effect on profit before tax is not material. If auditors have determined overall materiality using profit before tax as the benchmark, does this offsetting mean that the misstatements in the individual accounts (ie, revenue and expenses) are not material?

The answer is 'it's unlikely'. ISA 450.A19 explains that if the auditors judge an individual misstatement to be material, it is unlikely that it can be offset by other misstatements. Auditors need to think carefully about whether users' views of the financial statements could be affected if the revenue and expenses were restated to their correct amounts – perhaps the restated amount would show that revenue has actually decreased rather than increased in relation to the prior year, and that could be important to users' assessment of the entity's performance.

Sometimes there will be misstatements that affect the same line item.

Testing of balances within accounts receivable might have found one item overstated by £4,000 and another item understated by £1,000. Although auditors would report both misstatements to management (if above the clearly trivial threshold), they can evaluate the impact of this misstatement based on the net amount of £3,000.

Disclosure misstatements
As with any other misstatements, auditors need to record incomplete, omitted or inaccurate financial statement disclosures unless they are clearly trivial, and determine whether they are material. Some of the disclosures may be narrative rather than containing monetary amounts, or at least be a combination of narrative and monetary amounts. It can be difficult to assess whether a misstatement in a narrative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity, and as ISA 450.A17 notes, it involves the exercise of professional judgement.

ISA 450.A17 gives the following examples where such misstatements may be material:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.
- The omission of information about the events or circumstances that have led to an impairment loss (eg, a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.
- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.
- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

ISA 450.A22 also notes that misstatements in disclosures could also be indicative of fraud, and gives the following examples where this may arise:

- misleading disclosures that have resulted from bias in management's judgements; or
- extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

Areas where disclosure issues can arise in practice include, for example:

- disclosure of accounting estimates and, in particular, the adequacy of disclosure of management's sensitivity analysis – management may wish to avoid/obscure disclosure of how a relatively small movement in a key assumption could lead to an impairment charge; or
- going concern uncertainties, and, in particular, whether the disclosure makes it clear that there is a material uncertainty that may cause significant doubt about the entity's ability to continue as a going concern.

ISA 450.A4 explains that auditors accumulate misstatements in disclosures that are not clearly trivial to assist them in evaluating the effect of such misstatements on the relevant disclosures and the financial statements as a whole. This can sometimes cause confusion for auditors, because financial reporting standards do not require disclosure of immaterial matters. Therefore, if management omits a disclosure that it believes is immaterial, and the auditors agree, should they report the omission as a misstatement to those charged with governance (assuming it is not clearly trivial)? One view is that it is not a misstatement because there is no requirement to disclose immaterial matters, and therefore it need not be reported on the summary of misstatements. But the auditors need to discuss the matter with those charged with governance to obtain their view on whether they believe it is immaterial, and for that reason auditors may consider it necessary to include it on the summary of misstatements.

Impact of uncorrected misstatements related to prior periods
In considering misstatements, auditors need to consider the impact of misstatements arising in prior periods. For example, if an adjustment has a recurring impact each year (such as a recurring sales cut-off adjustment), the prior year effect needs to be taken into account, which could have the effect of increasing or decreasing the overall level of misstatement.

ISA 450.A23 explains that the cumulative effect of immaterial uncorrected misstatements related to prior periods can have a material effect on the current period's financial statements. It says that there are different acceptable approaches to evaluating such uncorrected misstatements on the current period's financial statements and that using the same evaluation approach provides consistency from period to period.

Consider the situation where an expense item has been over-accrued each year for 5 years, by an amount of £10,000 each year. Each year this amount was assessed as immaterial and not corrected. By year 5, the cumulative effect on the balance sheet is £50,000 and this is now considered material. Applying one method of evaluation, the full amount of the misstatement (£50,000) might be corrected in the current period income statement. Alternatively, only the current period misstatement of £10,000 would be corrected through the income statement and the remaining £40,000 would be adjusted through opening retained earnings. The evaluation method applied is a matter of judgement, but should be applied consistently, and should also take into account the financial reporting framework and how that framework deals with correction of prior year misstatements.

Forming an overall judgement
Overall, it is important that auditors consider both its size and its nature in determining whether a misstatement is material. Therefore, rather than being fixated with a numerical assessment, they need to apply professional judgement. Taking into account all of their knowledge of the entity and its environment, auditors need to remember that the 'test' is whether, in their judgement, users of the financial statements may be influenced by misstatements identified during the audit that remain uncorrected.

CONSIDERING THE IMPACT OF MISSTATEMENTS ON THE AUDIT

Where misstatements are identified during the course of the audit, auditors assess the impact on the overall audit strategy and plan, including:

- **Understanding why the misstatement arose:** for example, was it due to a deficiency in controls and if so, could there be other similar misstatements, particularly if there were systemic control issues?
- **Assessing the risk of further undetected misstatements:** if the aggregate of the identified misstatements is close to materiality, there could be an unacceptably high risk that the financial statements are materially misstated taking into account that there could be further undetected misstatements.

Consider the situation where auditors have determined overall materiality to be £100,000. During the audit, factual and judgemental misstatements have been identified that, in aggregate, impact profit before tax by £90,000. The amount is below overall materiality and the auditors have not identified any factors such as management bias suggesting that this is qualitatively material. Therefore, the auditors may conclude that the misstatements are not material. But how confident can they be that there are no further undetected misstatements? The use of performance materiality to plan and perform audits provides some allowance for the risk of undetected misstatements but in this situation, it would make sense for auditors to at least ensure that factual misstatements are corrected.

If misstatements in aggregate are close to overall materiality, there are a number of actions that auditors might take:

- Request that the identified misstatements are corrected.
- Request entity management to examine the affected areas to understand why the misstatements occurred, and perform procedures to determine whether there are further misstatements. In this case, auditors need to perform appropriate testing of management's procedures.
- Perform additional testing focused on the areas considered to be of greater risk of misstatement, for example additional substantive testing in those areas where misstatements were found. This might include additional work on all significant accounting estimates if there is evidence of management bias.

It may also be necessary to reduce the original performance materiality, and reassess the impact on testing throughout the audit. This is likely to be necessary only where pervasive misstatements have been identified.

5. Materiality in group audits

Just as auditors would for a single entity audit, group auditors use professional judgement to determine the following:

- group materiality;
- lower materiality levels for specific account balances, classes of transactions or disclosures;
- group performance materiality; and
- the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

They would similarly be expected to document their rationale for the professional judgements made above in accordance with ISA 320.14.

A key difference is that in addition to determining the above, group auditors also have to determine levels of component materiality for components that have audits or reviews for the purposes of the group audit. In this section we look specifically at:

- how to determine component materiality;
- who should determine component materiality;
- determining component performance materiality;
- setting a clearly trivial threshold;
- determining component materiality for associates and joint ventures; and
- the effects of changes in group materiality.

HOW TO DETERMINE COMPONENT MATERIALITY

There is no guidance in ISA 600 *Special considerations – audits of group financial statements (including the work of component auditors)* about how to determine component materiality other than it must be lower than group materiality. The reason it must be lower than group materiality is similar to the reason for the requirement to determine performance materiality: to reduce to a sufficiently low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements will exceed materiality for the group financial statements as a whole.

The probability of undetected misstatements and uncorrected misstatements aggregating together to a material amount will normally be expected to increase as the number of components increases – particularly where all components are not being subject to audits or reviews for the purposes of the group audit.

The determination of levels of component materiality will be a professional judgement based on quantitative and qualitative factors depending upon the number, nature and characteristics of the components. It is common that different levels of component materiality are set for different components.

Component materiality must be used for audits or reviews of components' financial information. However, ISA 600 does not specify that component materiality **must** be used where either the group auditors or component auditors are only performing (a) an audit of one of more account balances, classes of transaction or disclosures or (b) specified procedures relating to likely significant risks of the group financial statements. In these cases, component materiality is still often determined and used but it is not required by the ISA.

ISA 600 makes clear that component materiality need not be an arithmetical portion of materiality for the group financial statements as a whole and, consequently, the aggregate of component materiality for the different components may exceed the materiality for the group financial statements as a whole.

There are different methodologies that group auditors commonly use to determine levels of component materiality, including the following approaches.

- Setting an absolute limit on the aggregate of component materiality relative to group materiality (that is then divided up between the components in scope). The limit would be expected to increase as the number of components increases.
- Having levels of component materiality that vary depending on the relative size of the component to the group, but with no absolute limit. This could mean that a component that accounted for say 50% of the group could have a component materiality that was in excess of 50% of group materiality.
- Using the materiality appropriate for the individual statutory audit of the component.

Refer to the example at the end of this section to see how component materiality may be determined in these circumstances.

Factors which may influence component materiality levels include:

- the fact that component materiality must always be lower than group materiality;
- the size of the component (its individual financial significance to the group);
- whether the component has a statutory audit, in which case the level of materiality for statutory audit purposes (which is likely to be lower) may be used;
- the characteristics or circumstances that make the component significant;
- the strength of the component's control environment;
- whether the component is new to the group and so the group auditors have less of an understanding of its operations;
- whether the component's operations are similar to the rest of the group; and
- the likely incidence of misstatements, taking account of risk assessment and past experience.

In many cases statutory materiality for a component would naturally be expected to be lower than group materiality, however, this is not necessarily the case. For example, where group materiality is determined as a percentage of profit before tax and there are components that are both profitable and loss making, it could be possible for the profit of an individual component to be higher than group profit. In this case, the component materiality used would have to be lower than group materiality (it could not be capped at group materiality), although how much lower is a matter of professional judgement.

In terms of the relative size of the component, an important consideration is that the component materiality being used should be meaningful. If a very high component materiality is used for a small component, it may be that only a few account balances, classes of transactions or disclosures would be material and therefore performing work at that level would not be expected to identify any material misstatements, such that the value of performing any work on that component could be questioned.

> Component materiality is set at £100,000 but the only account balances, classes of transactions or disclosures that exceed that level are revenue (£150,000) and cost of sales (£120,000). Setting component materiality at this level is unlikely to result in meaningful audit work being performed, as it is highly unlikely that the component auditors would identify any significant misstatements. Possible solutions include requesting the component auditors to use a lower materiality, the group auditors to scope out that component or the group auditors to request that only limited audit procedures are performed in relation to revenue and cost of sales.

WHO SHOULD DETERMINE COMPONENT MATERIALITY

Setting component materiality is a matter for group auditors, because its function is to help them perform the group audit. Group auditors will often specify a component materiality which is higher than the materiality that would be used for a statutory audit. In this situation, as the component auditors may already be performing audit work for the purposes of the statutory audit at the same time as the group audit, the component may agree with the group auditors to report at the lower statutory materiality.

Group auditors and component auditors may adopt different approaches to determine materiality, including using different benchmarks. Ultimately, the group auditors are responsible for determining the level of component materiality and, while their methodology may be different to the method that would have been determined by component auditors or that the component auditors will use for their statutory audit, the component auditors should be able to report back to the group auditors using the component materiality determined by the group auditors.

DETERMINING COMPONENT PERFORMANCE MATERIALITY

In the same way that group auditors will need to set a group performance materiality, component performance materiality will also need to be determined. This can be done by either the group auditors or the component auditors.

Where the group auditors do not directly determine component performance materiality, they will need to evaluate the appropriateness of component performance materiality determined by the component auditors.

While not explicitly stated by ISA 600, component performance materiality should be less than group performance materiality. In many cases this would not be an issue but it could be problematic where component materiality is a high percentage of group materiality and component performance materiality is a high percentage of component materiality.

> Group performance materiality is set at 80% of group materiality. At component A, component materiality is 90% of group materiality and component performance materiality is 90% of component materiality, which would mean that component performance materiality is 81% of group materiality and therefore higher than group performance materiality.

When evaluating whether the levels of component performance materiality are appropriate, the group auditors may wish to consider the judgements made when determining component performance materiality and whether they are consistent across the group and, if not, that they understand the rationale for the differences.

> Group performance materiality is set at 75% of group materiality. At component A, component performance materiality is set at 85% of component materiality. For component A, the group auditors may want to understand why a relatively higher performance materiality was applied to this component than for the group as a whole. A possible explanation could be because there have been no misstatements identified at this component in the past compared to recurring misstatements at other components in the group.

The determination of component performance materiality as a percentage of component materiality is not strictly a mathematical exercise and the individual facts and circumstances of the component audit engagement will influence the determination of component performance materiality. The factors already discussed in **Determining performance materiality** are equally applicable when considering component performance materiality.

CLEARLY TRIVIAL THRESHOLD

Group auditors are required to determine a threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements and ask component auditors to report all uncorrected misstatements above that threshold. While component materiality may vary by component, group auditors may choose to set only one threshold for component auditors to report uncorrected misstatements.

Irrespective of the threshold for uncorrected misstatements communicated by the group auditors, the component auditors will also be expected to identify their own clearly trivial threshold for the purpose of accumulating misstatements in order to evaluate the effect of identified misstatements on the component audit and the effect of uncorrected misstatements for that component. However, they only need to report uncorrected misstatements above the group reporting threshold as well as other smaller misstatements that the component auditors consider need to be reported because of the nature of the misstatement.

Group materiality is set at £200,000 and the group reporting threshold for misstatements is £10,000 (5% of group materiality). Component materiality is set at £50,000. The component auditors determine their own clearly trivial threshold of £2,500 and accumulate all misstatements above that level. In this case, the component auditors would still only report to the group auditors on misstatements they have identified above £10,000, assuming that there are no misstatements below that level that need to be communicated because of their nature.

DETERMINING COMPONENT MATERIALITY FOR JOINT VENTURES AND ASSOCIATES

Determining component materiality for associates or joint ventures can be difficult, particularly when the associates or joint ventures are significantly larger than the group itself. This might result in the auditors of the associate or joint venture appearing to use a materiality that is higher than group materiality. However, given that the group does not fully consolidate the results of the associate or joint venture, it may be appropriate to consider their percentage ownership when determining whether a suitable component materiality has been applied.

A group holds a 30% investment in an associate that is much larger than the group as a whole. Group materiality has been set at £100,000 and the materiality that has been determined for the statutory audit of the associate is £150,000. Multiplying the materiality being used for the associate (£150,000) by the ownership percentage (30%) would result in an effective component materiality of £45,000, which is less than the group materiality of £100,000.

THE EFFECT OF CHANGES IN GROUP MATERIALITY

If the group auditors consider that a change in materiality is required (for example, because group materiality was originally based on projected numbers and the final numbers are significantly lower than expected), then clearly any changes in group materiality would also need to be considered for their effect on the materiality levels used by the components.

In these cases, it does not automatically follow that component materiality must be changed – particularly where component materiality is significantly lower than the originally determined group materiality and would still be lower than the revised group materiality. Naturally, where component materiality is a high percentage of group materiality, it will be more of an issue, especially where it would mean that component materiality would be higher than group materiality.

If the group auditors determine that changes are needed, they will need to communicate this as soon as possible to the component auditors so that the component auditors can determine what additional work is required and perform any additional work in time for the group reporting deadline.

Given the issues that can arise in this case, where group materiality is based on projected numbers, group auditors may want to build in some conservatism when determining levels of component materiality, so that any changes in group materiality would not necessarily require a change in component materiality levels.

Misstatements identified at components

Levels of group and component materiality, as well as performance materiality, may need to be reconsidered as a result of any misstatements identified at components. Therefore, component auditors need to notify the group auditors promptly if they identify any significant misstatements at the component level, so that the group auditors can consider the impact on the group audit.

EXAMPLES: DETERMINING COMPONENT MATERIALITY

Example 1
Group materiality was determined to be £200,000 on the basis of net assets. The group is made up of 10 components from the UK and overseas that have the following relative sizes:

Component	Statutory audit required	Size as a proportion of net assets	Size as a proportion of revenue
A*	No	30%	20%
B*	Yes	20%	25%
C*	Yes	10%	15%
D+	No	10%	8%
E+	No	10%	5%
F*	Yes	5%	10%
G	No	5%	5%
H	No	4%	8%
I*	Yes	3%	2%
J	No	3%	2%

* Full scope audit performed for the purposes of the group audit for both significant and non-significant components

+ Audit of one or more account balances, classes of transactions or disclosures are performed for the purposes of the group audit

For components where a statutory audit is required (B, C, F, I), the group auditors originally determined the following after considering qualitative factors:

Component	Qualitative factors taken into account by the group auditors	Component materiality determined by the group auditors	Statutory materiality determined by the component auditors
B	Significant component Operations are substantially the same as the rest of the group Been part of the group for over 10 years	£130,000	£150,000
C	Been part of the group for over 10 years Operations are substantially the same as the rest of the group	£90,000	£75,000
F	Operations very different as treasury company only	£40,000	£30,000
I	Operations are substantially the same as the rest of the group Significant errors detected in the previous period	£30,000	£25,000

In this situation, the group auditors would accept for components C, F and I for the component team to use their statutory materiality. However, for component B the component auditors would not be able to use statutory materiality as this exceeds the determined component materiality.

For the remaining components within scope (A, D, E), component materiality will need to be determined, again also considering qualitative factors, but it does not necessarily need to be a simple mathematical calculation. Therefore, the determined component materiality may be a greater proportion of group materiality than the component's relative size to the group.

Component	Qualitative factors taken into account by the group auditors	Component materiality determined by the group auditors
A	Significant component Been part of the group since its inception Main trading entity of the group – performs a number of activities not undertaken by other group companies Bespoke computer system/control environment	£150,000
D	New subsidiary of the group acquired during the year New activities being undertaken by this component compared to the group Has seen rapid expansion in activities since acquisition Changed to group's computer system in the year	£80,000
E	Been part of the group for over 5 years Operations are substantially the same as the rest of the group	£90,000

This means that the respective levels of component materiality are as follows:

Component	Component materiality determined by the group auditors	Component materiality as a percentage of group materiality
A	£150,000	75%
B	£130,000	65%
C	£75,000	37%
D	£80,000	40%
E	£90,000	45%
F	£30,000	15%
I	£25,000	13%
Total of component materiality	**£580,000**	**290%**

Example 2
Same situation as example 1, but the group auditors' audit methodology specifies that the total of component materiality for this number of components subject to audit cannot exceed three times group materiality.

In the table below, the total of £600,000 (£200,000 x 3) has been allocated proportionately across the components in scope while also taking into account qualitative factors discussed above:

Component	Size as a proportion of net assets	Weighting of net assets of components in scope	Adjustment for qualitative factors	Component materiality determined by the group auditors	Component materiality as a percentage of group materiality
A	30%	34%	Yes	£184,000~	92%
B	20%	23%	No	£138,000	69%
C	10%	11%	Yes	£75,000^	38%
D	10%	11%	Yes	£60,000@	30%
E	10%	11%	Yes	£80,000=	40%
F	5%	6%	No	£30,000	15%
I	3%	4%	No	£24,000#	12%
Total of levels of component materiality	**88%**	**100%**	**-**	**£591,000**	**296%**

~ Limited to 90% of group materiality as 34% x £200,000 x 3 = £204,000, which was in excess of group materiality

^ This is statutory materiality of £75,000. Adjusted up from the calculated figure of £66,000 (11% x £200,000 x 3) to reflect that this is a long-standing subsidiary

@ Adjusted down from £66,000 to reflect that this is a new subsidiary acquired in the year

= Adjusted up from the calculated figure of £66,000 to reflect that this is a long-standing subsidiary

The component materiality is less than the statutory materiality of £25,000

6. Communications with management and those charged with governance

There will be a number of communications with both management and those charged with governance during the audit in relation to both materiality and the misstatements identified by the auditors.

While auditors have always been required to communicate details of the misstatements that they identified, practice in relation to communicating the level of materiality used itself has been more varied.

This section looks at communications:

- at the planning stage;
- as the audit progresses; and
- in the final stages of the audit.

PLANNING

Are auditors required to communicate the level of materiality?
There is no requirement for auditors to communicate the level of materiality that they expect to use for the majority of audits. ISA 260.A13 states that, as part of communicating an overview of the planned scope and timing of the audit, auditors **may** communicate the application of the concept of materiality in the context of the audit.

This is in contrast to the requirements for public interest entities incorporated in the EU (Regulation (EU) No 537/2014), where there is an explicit requirement to communicate the materiality level used, including where relevant, the level(s) applied for particular classes of transactions, account balances or disclosures. In addition, auditors of public interest entities incorporated in the EU are required to communicate the qualitative factors that were used when setting materiality. The timing of this required communication is not stated, but it would make sense to communicate during the planning process.

While the requirements for public interest entities incorporated in the EU do not apply to other entities (in the absence of equivalent local regulations), if auditors communicate the materiality levels used, these requirements provide a useful basis for what to include in the communication. Clearly, it would be helpful to communicate the rationale for determining the level of materiality selected and any lower levels of materiality used. In the case of a group audit, the auditors may also wish to communicate the levels of component materiality that are being used.

While auditors may report on materiality, they may still choose not to report on performance materiality as this can often be a difficult concept to communicate succinctly.

Discussions with those charged with governance
Although not required, auditors may wish to discuss the level of materiality being used and the threshold for reporting misstatements with those charged with governance. This is to give those charged with governance the opportunity to see whether they agree that the levels being proposed are appropriate, as they are likely to have their own view of materiality and the threshold for reporting misstatements.

If those charged with governance want the auditors to use a different level of materiality, the auditors would need to understand the rationale for this. The auditors would have less of an issue if those charged with governance want a lower level of materiality, provided that they understand this would require more audit work and potentially increase the audit fee. It would, however, be inappropriate if those charged with governance want the auditors to increase the level of materiality beyond the level determined by the auditors, especially if the main motivation is to reduce the audit fee.

While auditors set a clearly trivial threshold for accumulating misstatements, those charged with governance may state that they are interested in misstatements at a different level. If those charged with governance said that they were interested in misstatements below the threshold set by the auditors, the auditors will need to assess the extent to which it is possible to accumulate misstatements at this lower level as the very fact that those charged with governance have said they are interested in misstatements at that lower level may mean it is difficult to dismiss them as clearly trivial. If those charged with governance state that they were only interested in misstatements at a higher level than the auditors (eg, the auditors have determined a clearly trivial threshold of £2,000 but those charged with governance have stated that they are only concerned about misstatements in excess of £5,000), then the auditors will still have to communicate all the misstatements but may choose not to report them individually. See below for an example of how these misstatements could be communicated.

AS AUDIT PROGRESSES

Auditors may need to revise materiality as the audit progresses. If they have previously communicated the level of materiality to those charged with governance, then it would be expected that they would communicate any change in that level as soon as practicable. In that communication, the auditors would also be encouraged to set out the rationale for the change in materiality being applied.

Unless precluded by law or regulation, ISA 450.8 requires that auditors communicate all misstatements accumulated to the appropriate level of management on a timely basis, so that management has time to evaluate the effect of the misstatements.

Where auditors are communicating misstatements to management, they are also required by ISA 450.8 to request that management corrects those misstatements.

FINAL STAGES OF THE AUDIT

ISA 450.12 requires auditors to communicate uncorrected misstatements (other than those that are deemed to be clearly trivial) to those charged with governance, again unless prohibited by law or regulation. Auditors will need to take into account the nature of the misstatement in determining whether the misstatement is clearly trivial and needs to be communicated, not just its size. Again, auditors are explicitly required to request that the misstatements be corrected.

An example of how to communicate this is set out below.

EXAMPLE: SUMMARY OF UNCORRECTED MISSTATEMENTS IDENTIFIED

The following uncorrected misstatements have been identified up to the date of this report which we request that management corrects as required by International Standards on Auditing.

	Type of mis-statement	Debit/ (credit) to income statement £	Debit/ (credit) in net assets £	Debit/ (credit) to prior year retained earnings £
Misstatements identified in current year				
Dr Impairment charge	Judgemental	7,000		
Dr Property, plant and equipment			(7,000)	
Dr Deferred income	Factual		12,000	
Cr Revenue		(12,000)		
Misstatements identified in prior years carried forward				
None				
Aggregation of misstatements individually < £5,000	Factual	6,000	(6,000)	
Total		**1,000**	**(1,000)**	-

There is no requirement to communicate corrected misstatements but this is encouraged as it may assist those charged with governance in fulfilling their governance responsibilities. In particular, where a large misstatement is identified by the auditors and corrected by management, the auditors may determine that those charged with governance need to be aware of that misstatement. It might also assist those charged with governance in discharging their responsibilities around internal control.

ISA 450.14 also requires auditors to obtain a representation from those charged with governance as to why the misstatements communicated have not been corrected and their reasons for not correcting them. Generally, there will only be two reasons for this – they are not correcting because those charged with governance believe that the misstatement is immaterial or because they disagree with the auditors over a judgemental misstatement. The auditors would only be able to accept misstatements not being corrected provided that individually and collectively the misstatements are immaterial to the financial statements as a whole.

7. *Documentation*

This section looks at:

- documenting materiality
- documenting identified misstatements.

DOCUMENTING MATERIALITY

ISA 320.14 requires auditors to document materiality amounts and the factors considered in their determination.

The documentation therefore includes an explanation as to how the specific circumstances of the entity were considered, together with the judgements made in determining materiality, including:

- overall materiality;
- performance materiality;
- any lower amounts of specific materiality for particular classes of transactions, account balances or disclosures (and any related performance materiality for these items);
- the amount considered clearly trivial for the purposes of recording misstatements; and
- on a group audit, the component materiality for those components where component auditors will perform an audit or a review for the purposes of the group audit. An example of documenting the determination of component materiality is included in **Section 5, Materiality in group audits**.

The documentation may include, for example, notes of a planning meeting where materiality is discussed. There is no prescribed format for the documentation – what is important is that it records auditors' rationale for the determination of materiality and not just the amounts. An example of documenting overall materiality and performance materiality is included in **Section 3, Determining materiality**. Further examples of documenting overall materiality, where different benchmarks are used, are included at the end of this section.

Where overall materiality takes into consideration an assessment of the views of users of the financial statements such as analysts, appropriate evidence such as relevant extracts from analysts' reports is included in the audit file.

Where materiality is revised during the audit (for example, where overall materiality was originally determined based on forecast information), details of the revision are recorded in the audit file. This will include documentation of auditors' assessment of the impact on the audit strategy and plan.

The extent of documentation required depends on the complexity of the materiality judgements – in more complex situations, more explanation is likely to be needed.

Auditors may develop a template to help ensure that each of the relevant materiality measures are documented. However, because of the professional judgement inherent in determining materiality, it is important that any such template allows for the engagement team to record their specific rationale for their decisions.

DOCUMENTING IDENTIFIED MISSTATEMENTS

The summary of misstatements used to aggregate misstatements above the clearly trivial threshold determined in the audit plan is communicated to management, and to the extent that misstatements remain uncorrected it is included in, or attached to, the representation letter (as required by ISA 450.14). An example of a summary of misstatements is included in **Section 6, Communications with management and those charged with governance**.

EXAMPLES: DOCUMENTATION

Example 1: Use of net assets as the benchmark for overall materiality, with lower specific materiality for certain areas
The entity is a property investment company and its strategy is primarily to develop properties in order to benefit from growth in the value of those properties. In addition, it generates rental income. The principal key performance indicator on which management judges performance, and which it discloses prominently in the annual report, is the total property return, being capital growth including gains and losses on disposal of property, plus rents received less associated costs.

The most important measure for users of financial statements is therefore the value of the investment property. As a result we have selected net assets as the benchmark for materiality and will use 1% of net assets. We have considered qualitative factors in determining this, in particular, that the principal financial covenant in the entity's bank loan agreement is a loan to value ratio. This reinforces the importance of net assets but given the headroom in the covenant, we are satisfied that 1% of net assets is appropriate.

Although the focus is on the fair value of the properties, the users of the financial statements will not disregard the financial performance in terms of rental income and associated costs, as it forms a small part of the total property return. Accordingly we will apply a lower specific materiality to items in the income statement and statement of financial position other than investment properties and the fair value movements in investment property. This will be based on 5% of rental income less associated costs.

Performance materiality will be 75% of overall materiality (or 75% of the lower specific materiality where applicable). This is because in prior years there have been few misstatements identified and we have found internal controls to be effective.

The clearly trivial threshold will be 5% of overall materiality because there have been few misstatements identified on prior audits.

In summary:

	£'000
Net assets	42,056
Overall materiality (1%)	400
Performance materiality	300
Lower specific materiality for items other than investment properties and fair value movements in investment property	30
Clearly trivial threshold	20

Example 2: Use of adjusted profit before tax as the benchmark for overall materiality
The entity is a private company which is considered to be profit oriented. Overall materiality has been determined based on 10% of profit before tax (PBT) from continuing operations. This is the measure identified as relevant to users of the financial statements such as management and the owners, who focus on profit as it impacts, directly or indirectly, on their remuneration and dividends and their ability to reinvest in order to grow the business.

PBT has been adjusted for the impairment charge – as a result of the impact of a reassessment of sales prices on cash flow-forecasts, an exceptional impairment charge has been recognised this year. There have been no similar charges last year, and it is not expected that such impairment will recur in the future. We have therefore determined materiality disregarding the impairment charge as we believe that the users of the financial statements will be focusing on the underlying performance of the entity. We consider it appropriate to use 10% of this adjusted figure, as that is a generally accepted percentage for PBT for private companies and we consider it appropriate for use with the adjusted PBT.

Overall materiality has therefore been determined as follows:

	£'000
PBT	6,186
Add back impairment charge	450
Adjusted PBT	6,636
Overall materiality (10%)	650 (rounded down from 664)

Given its potential sensitivity, we will use a lower specific materiality for the impairment charge of £50,000.

Performance materiality will be 75% of overall materiality, taking into account our experience of identifying very few misstatements on prior audits.

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