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# MATERIALITY IN PLANNING AND PERFORMING AUDIT

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A financial statement audit enhances the degree of confidence of intended users in the entity's financial statements. Accordingly, due to the importance of auditors' attestation, the auditing standards require auditors to design the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

The concept of materiality is applied by the auditor when:

- Planning and performing the audit [ISA 320[1]];
- Evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements [ISA 450[2]]; and
- Forming an opinion on the financial statements [ISA 700[3]].

This document aims to provide some practical considerations in applying the concept of materiality in planning and performing the audit.

## What is materiality in the context of an audit?

Materiality addresses the significance of financial statement information to economic decisions made by users on the basis of the financial statements.

The assessment of what is material is a matter of professional judgment. ISA 320 specifies 3 main characteristics of materiality:

- Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users based on the financial statements;
- Judgments about materiality are made in context of surrounding circumstances, and are affected by the size (quantitative - the monetary amount involved) and/or nature of misstatements (qualitative); and
- Judgments about materiality are based on considerations of common financial information needs of users as a group.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material which provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining further audit procedures.

ISA 320 states that materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances surrounding some misstatements may lead the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the nature of misstatements must be considered by the auditor when evaluating their effect on the financial statements.

[1] ISA 320, Materiality in Planning and Performing an Audit

[2] ISA 450, Evaluation of Misstatements Identified during the Audit

[3] ISA 700, Forming an Opinion and Reporting on Financial Statements

Misstatements may arise from a number of causes and can be based on the following:

- Size;
- Nature of the item; and
- Circumstances surrounding the occurrence of misstatement.

Examples of misstatements which may be significant to users of the financial statements due to the nature rather than size are as follows:

- Transactions involving related parties may be very significant to a person making a decision based on the financial statements;
- Illegal acts; or
- Non-compliance with regulatory requirements.

### What are the different types of materiality?

ISA 320 provides a number of distinctions into assessment of the materiality as shown in the diagram below:

| FINANCIAL STATEMENT LEVEL | ACCOUNT BALANCE, CLASS OF TRANSACTIONS AND DISCLOSURES LEVEL |
|---|---|
| Overall Materiality | Specific Materiality |
| Overall Performance Materiality | Specific Performance Materiality |

Note: The terms "overall" and "specific" materiality are used in the International Federation of Accountants ("IFAC") Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities (hereafter referred to as "ISA Guide") and are not terms used in ISAs.

| | |
|---|---|
| Overall Materiality | • Relates to materiality for the financial statements as a whole.<br>• Established based on what could reasonably be expected to influence the economic decisions of users taken on the basis of financial statements. |
| Specific Materiality | • Established for classes of transactions, account balances or disclosures for which misstatements of lesser amounts than overall materiality could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. For example, disclosure note to the financial statements on management remuneration. |
| Performance Materiality | • The amount(s) set by the auditor at less than the overall materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds the overall materiality.<br>• If applicable, it also refers to the amount(s) set by the auditor at less than the specific materiality (this refers to specific performance materiality).<br>• Its purpose is to ensure immaterial misstatements less than the overall or specific materiality are identified and provides the auditor with a safety margin for possible undetected misstatements. This margin is between detected but uncorrected misstatements in the aggregate and the overall or specific materiality.<br>• It is used to assess the risks of material misstatement and design further audit procedures to respspond to assessed risks. |

## How to determine materiality?

### Overall Materiality

- A percentage is often applied to a chosen benchmark as a starting point determination.
- Examples of benchmarks (depending on the circumstances of the entity) include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

- Factors that may be considered in establishing benchmarks include:
  a) *The elements of the financial statements*
     What are the major elements of the financial statements that will be of interest to users; for example, assets, liabilities, equity, revenue and expenses?
  b) *Whether there are items on which users of the entity's financial statements will pay attention*
     What information will attract the most attention by users; for example users interested in evaluating financial performance will focus on profits, revenues or net assets.
  c) *The nature of the entity*
     Consider the nature of the entity, where the entity is in the life cycle (growing, mature, etc), and the industry and economic environment in which the entity operates.
  d) *The entity's ownership structure and the way it is financed*
     If the entity is financed solely by debt, users may put more emphasis on the pledged assets and any claims than on the entity's earnings.
  e) *The relative volatility of the benchmark*
     Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks such as gross profit or total revenues may be more appropriate.

- In relation to the chosen benchmark, the auditor would also need to consider whether an adjustment to the benchmark is needed for significant changes in the circumstances in the entity. For example, income from continuing operations could be adjusted for unusual or non-recurring revenue or expense items.

- The ISA Guide provides "Rules of Thumb" (for use as a starting point) to determining overall materiality as there is no specific guidance provided in the ISAs. Income from continuing operations (3% to 7%) is often used in practice as having the greatest significance to financial statement users. If income is not a useful measure (such as for a not-for-profit entity or where income is not a stable base), then consider other bases such as:
  a) Revenue or expenditure, 1% to 3%;
  b) Assets, 1% to 3%; or
  c) Equity, 3% to 5%.

## Specific Materiality

- Decision influencers include:
  a) Laws, regulations and accounting framework requirements (for example, related party transactions)
  b) Key industry disclosures (for example, research and development costs for a pharmaceutical company)
  c) Disclosure of significant events and important changes in operations (for example, discontinued operations).

- It will be useful to obtain an understanding of the views and expectations of those charged with governance and management in identifying whether there are particular items for which it would be appropriate to determine a specific materiality level(s).

- The ISA Guide "Rules of Thumb" provides that specific materiality level(s) can be determined by establishing a lower, specific materiality amount (based on professional judgment) for the audit of specific or sensitive financial statement areas.

## Performance Materiality

- Relevant factors that may be considered in determining performance materiality include the auditor's understanding of the entity, nature and extent of previous audits misstatements and expectations of nature and extent of misstatements in the current period.
- As there is no specific guidance given in the ISAs, the ISA Guide "Rules of Thumb" suggests using percentages range from 60% to 85% (of overall or specific materiality), depending on the risk of material misstatements. The higher the risk of material misstatements, the lower percentage should be used.

### Is there a need to revisit the initial materiality assessment?

- Yes, the auditor has to reconsider assessments of materiality if the auditor becomes aware of information during the audit that would have changed that determination of the amount(s) had it been known at the planning stage.
- If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor must consider whether it is necessary to revise performance materiality and whether further additional procedures are required.
- A revision to materiality levels as audit progresses may be required in the following circumstances:

| | |
|---|---|
| Overall Materiality | • A change in entity's circumstances (for example; sale of a part of the entity's business);<br>• New information; or<br>• A change in the understanding of entity and its operations (for example; actual financial results being very different from the anticipated period-end financial results). |
| Specific Materiality | • A change in the special circumstances. |
| Performance Materiality | • Changes in assessed risks;<br>• Nature and extent of misstatements found when performing audit procedures; or<br>• Change in understanding of the entity. |

### How to use materiality in planning and risk assessment?

During planning and risk assessment stage of the audit, materiality is used as follows:

| | |
|---|---|
| Planning | • Determine financial statement areas that require auditing.<br>• Set the context for the overall audit strategy.<br>• Plan the nature, timing, and extent of specific audit procedures.<br>• Deteming specific materiality and specific performance materiality.<br>• Evaluate evidence to determine any revision required to the materialty levels as audit progresses. |
| Risk Assessment | • Identify the relevant risk assessment procedures.<br>• Provide a context when evaluating audit evidence.<br>• Assess the impact of the risks identified.<br>• Assess the results of risk assessment procedures. |
| Team Meetings | • Ensure audit team understood the identified financial statements users and factors that will change their economic decisions. Such factors would include disposal of a major part of the business and significant difference between actual and anticipated results.<br>• Establish overall audit strategy.<br>• Determin the extent of testing in relation to performance and specific materiality.<br>• Identify critical audit issues and significant audit areas. |

### How to use materiality in performing audit procedures?

- In performing audit procedures, materiality is used to:
- Identify further audit procedures.
- Determine items for testing and whether to use sampling.
- Assist to determine sample sizes.
- Evaluate sampling errors by extrapolating across population to calculate 'likely' misstatements.
- Evaluate the aggregate total errors at the account level, financial statement level and opening retained earnings.
- Assess results of procedures.

## Is documentation required on materiality?

- Yes, auditors need to provide documentation on materiality. As materiality amounts are based on auditor's professional judgment, it is important that all factors and amounts involved in determining materiality are properly documented.

- The auditor shall include in the audit documentation the following amounts and factors considered in the auditor's determination of:
  a) Overall materiality;
  b) If applicable, the specific materiality level(s);
  c) Performance materiality; and
  d) Any revisions to the above factors as the audit progresses.

- Example documentation for illustrative purposes only.

### Overall materiality

The main users of the financial statements are the bank and the shareholders. Based on consideration of user needs, materiality for financial statements as a whole has been set at RM25,000 [RM500,000*5%]. This is based on 5% of an estimated profit before tax of RM500,000, which is a consistent basis to that used in previous audits. Other bases for materiality were also considered but it was felt that profit before tax was the most meaningful amount in relation to the identified financial statement users. An unadjusted profit before tax is appropriate as there are no exceptional items affecting profit before tax.

### Specific materiality

A lower level of materiality has been set for related parties transactions at RM13,000.

### Performance materiality

In assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures, performance materiality has been set at RM18,750 [RM25,000* 75%] (and RM11,050 [RM13,000* 85%] for related parties transactions). This is deemed sufficient as, on the basis of past audit errors (which have been primarily of a cut-off nature); there is a low probability that the aggregate of uncorrected and undetected misstatements will exceed the overall materiality.

## The Malaysian Institute Of Accountants ("MIA")

MIA is a statutory body established under the Accountants Act, 1967 to regulate and develop the accountancy profession in Malaysia. As at the date of this report, MIA has over 28,000 members. For more information please visit: www.mia.org.my

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To be a globally recognized and renowned institute of accountants committed to nation building.

## Mission

To develop, support and monitor quality and expertise consistent with global best practice in the accountancy profession for the interest of stakeholders.

## Objectives

1. To promote & regulate professional & ethical standards
2. To develop & enhance competency through continuous education & training to meet the challenges of the global economy
3. To enhance the status of members
4. To lead R&D for the enhancement of the profession
5. To inculcate a high sense of social responsibility

## The Use of the Word "Accountant"

In Malaysia, the word "accountant" is protected as provided for under the provisions of the Act which states that no one can hold himself out or practise as an accountant unless he is registered as a member of MIA.