Materiality in audits

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What is materiality?

The International Accounting Standards Board defines materiality as follows:

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

When preparing financial statements, an entity must determine materiality and ensure its financial statements are materially correct.

Materiality in audits

How does materiality apply in an audit?

The objective of a financial statement audit is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. This is a separate responsibility and a separate decision from that made by the entity itself when preparing the financial statements.

In auditing, materiality means not just a quantified amount, but the effect that amount will have in various contexts.

During the audit planning process the auditor decides what the level of materiality will be, taking into account the entirety of the financial statements to be audited. Materiality relates to both the content of the financial statements and the level and type of testing to be done. The decision is based on judgements about the size, nature and particular circumstances of misstatements (or omissions) that could influence users of the financial reports. In addition, the decision is influenced by legislative and regulatory requirements and public expectations.

If, during the audit, the auditor acquires information that would have caused it to determine a different materiality level, it will revise the materiality level accordingly.

Materiality = quantity and quality

Both the amount (quantity) and nature (quality) of misstatements are relevant to deciding what is material.

Quantitative

The materiality level is often determined by applying a percentage to a chosen benchmark. There is no definitive figure for this percentage, such as more than 10 per cent is material, because of the number of variables which could apply. Examples of benchmarks are categories of reported income such as profit before tax, total revenue, gross profit, total expenses, total equity and/or net asset value.

- Profit before tax from continuing operations is often used for profit-oriented entities.
- When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Using a percentage as a numerical threshold may provide the basis for a preliminary assumption that a deviation of less than that percentage is unlikely to be material. However, quantifying the size of a misstatement in percentage terms is only the start, and cannot be used as a substitute for a full analysis of all relevant considerations.

Materiality in audits

Qualitative

Materiality also relates to the nature of the item in the context of the particular circumstances of its misstatement.

Therefore magnitude alone, without regard to the nature of the item and the circumstances in which the decision has to be made, will not generally be sufficient basis for a materiality judgement.

The auditor also needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect. For example, an error in a month-end procedure could be an indication of a potential material misstatement if that error is repeated each month.

Similarly, if there is a deficiency in an internal control process, for example, the auditor needs to consider whether that deficiency might, by itself or in combination with other deficiencies, result in a material misstatement not being prevented or detected.

Examples of qualitative misstatements

- The inadequate or improper description of an accounting policy.
- Failure to disclose a breach of regulatory requirements when the imposition of regulatory restrictions will significantly impair operating capability.

The final call

There are no rules that can be applied consistently to determine materiality. Materiality is a relative term. What may be material in one circumstance may not be material in another.

The concept of materiality recognises that some matters, either individually or in aggregate, are important if the financial statements are to be presented fairly, in all material respects, in accordance with generally accepted accounting principles.

The auditor must therefore consider not only each misstatement separately, but also the aggregate effect of all misstatements.

In the end, the assessment of what is material is a matter for the professional judgement and experience of the auditor.

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