Audit Methodology Simulation

Audit Materiality

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About the Presenter

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Outline

- New Definition of Material
- Why is Materiality Important
- Application of Materiality
- Benchmarks and Measurement Percentages
- Performance Materiality
- Materiality for Specific Circumstances
- Trivial amount
- Reassessment
- Documentation

New Definition of MATERIAL

“

Information is MATERIAL if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

”

The changes are effective from 1 January 2020

Why Materiality is IMPORTANT

Risk assessment and planning

During this stage we will update – or for new clients, document from scratch – our understanding of the entity, including their internal controls and environment relevant to the audit. We will also determine planning materiality level, which we will use to help us identify risks of material misstatement. Once all of the risks are identified, including significant risks, we will develop our response to those identified risks.

Application of Materiality

Application of Materiality

- Planning and performing the audit
- Evaluating the effect of any identified misstatements (corrected and uncorrected) on the audit
- Evaluating the effect of any uncorrected misstatements on the financial statements
- Forming an opinion on the financial statements as a whole. [ISA 320.5, ISA 320.8, ISA 320.A1]

Benchmarks and measurement percentages

Benchmarks and measurement percentages some examples

Indicative Benchmark	Indicative Measurement percentage
Profit before tax	Up to 10%
Equity/net assets (except employee benefit plans)	Up to 10%
Gross profit	Up to 4%
Earnings before interest, tax, depreciation, and amortization (EBITDA)	Up to 5%
Total revenues	Up to 3%
Total expenses	Up to 3%
Total assets	Up to 2%

The above benchmarks and respective percentages are for indicative purpose only. It is the responsibility of the firm to select and apply the benchmarks and percentages appropriately.

Knowledge check - Relevant case facts

Last year, profit before tax was 1,600,000, and we used 10% of profit before tax to determine the materiality of 160,000. We determined that this was reasonable for these reasons:

- Privately held entity
- Year over year profit before tax was consistent with prior years
- We determined any misstatements above that amount would influence the economic decisions of the users of the financial statements

However, this year, profit before tax is projected to be close to breakeven, Revenues and margins are consistent with prior years, but in the current year, there is a 2,000,000 impairment of intangibles, which is driving down the profit.

The investors are very focused on profit before taxes are this drives their return on investment. They don't focus on revenues much, even if it is consistent year to year. Additionally, the investors are not going to focus on total assets either as most of the Company's assets are simply inventory.

Knowledge check

What is the most appropriate benchmark to use in determining materiality for the financial statements as a whole for the Company?

- Total revenues, because of its consistency year over year
- Profit before tax, with no adjustments
- Profit before tax, with an adjustment to add back the 2,000,000 impairment
- Total assets, since the Company is a manufacturing company

Knowledge check

The most appropriate benchmark is **Profit before tax, with an adjustment to add back the 2,000,000** impairment, as this appears to be a non-recurring charge in the current year. Because the investors are most focused on profit before tax, and do not focus heavily on total revenues nor total assets, adjusting profit before tax would be the most appropriate response in the circumstances.

Performance Materiality

Performance Materiality

- LESS than materiality
- REDUCE PROBABILITY of aggregate uncorrected and undetected misstatement
- a matter of PROFESSIONAL JUDGMENT
- should Not Exceed 75% of materiality

Pause & Think

What do you think?

Could there be situations where one or more specific classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the decisions of users?

Materiality for Specific Circumstances

Trivial Amount

Trivial amount

- clearly inconsequential, whether taken individually or in aggregate

Reassessment

Reassessment

- Revision as the audit progresses
- Reassessment prior to evaluating uncorrected misstatements

Knowledge check

In what situations an engagement team consider whether revisions to materiality are appropriate?

- The entity had a substantial sales in the 4th quarter that was not initially anticipated in the planning financial information that was used to determine initial materiality
- After determining materiality on the engagement, the team discovers an immaterial error due to a reconciliation difference
- The entity disposes of a major segment after materiality has been determined
- After determining materiality on the engagement, the team discovers a material fraud in revenues

Documentation

Documentation

ISA 320 requirements

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:
    a) Materiality for the financial statements as a whole (see paragraph 10);
    b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
    c) Performance materiality (see paragraph 11); and
    d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Wrap-up

Fact Check

- Can we determine separate materiality amounts for different statements (for example, the statement of financial position and statement of comprehensive income)?
- Is there a threshold whereby actual financial results differ from the anticipated results resulting in a need to revise materiality?
- Why is it important to reassess materiality prior to evaluating the effect of uncorrected misstatements?
- When we have a lower materiality amount for a particular class of transactions, account balance, or disclosure, do we need a lower trivial amount?
- Can materiality for a particular class of transactions, account balance, or disclosure be higher than materiality for the financial statements as a whole?

Think back

- How would you apply this?
- How this is different from what you have done in the past?

Thank you