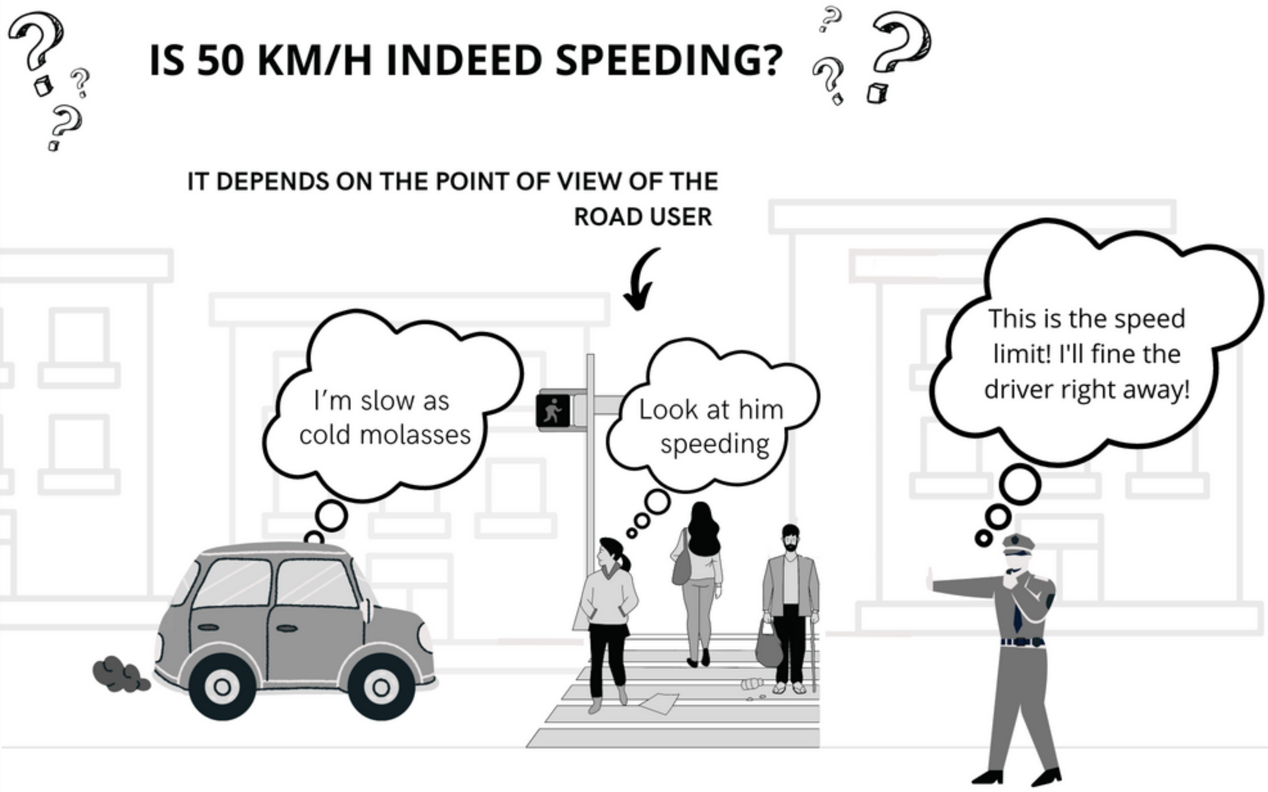
Selected aspects of materiality estimation, obligation of applying it in the audit and documentation

In the audit files inspected by the Polish Agency for Audit Oversight, irregularities in the area of materiality are very often indicated. With this in mind, the Agency draws attention in this publication to selected aspects of estimating materiality, the obligation of applying it in the audit and documenting it.

It is important to remember that the auditor is required to apply the concept of materiality throughout the audit, both in planning, performing the audit, and in evaluating the effect of identified misstatements and uncorrected misstatements on the audited financial statements.

Reference to the issue of materiality already appears in the overall objective of the audit, which is to obtain reasonable assurance that the financial statements as a whole are free from material misstatements - regardless of whether due to fraud or error. As a result, this enables the auditor to express an opinion as to whether the financial statements have, in all material respects, been prepared in accordance with the applicable financial reporting framework (ISA 200.11(a)).

When are misstatements considered material?



- *The auditor should determine materiality at the level of the audited financial statements guided by the perception of the users' needs (ISA 320.4).*
- *The auditor should identify the users of the financial statements and their needs, and include the conclusions of his considerations in the audit documentation.*

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. (ISA 200.6). Therefore, the auditor should determine materiality at the level of the audited financial statements guided by the perceived needs of the users of the financial statements (ISA 320.4). To do so, the auditor should first identify the users of the financial statements and their needs, and include the conclusions of his or her deliberations in the audit documentation.

Qualitative approach to materiality

Considerations of materiality should include both quantitative and qualitative considerations. In some cases, even misstatements involving relatively small amounts can have a material impact on the financial statements.

Possible qualitative factors when considering materiality include:

- perception of users' needs, including information on which areas of the financial statements interest them most,
- profitability trends,
- impact of irregularities resulting from non-compliance with debt agreements or other contractual requirements,
- improper selection or application of accounting policies that have an immaterial effect on the financial statements for the current period, but are likely to have a material effect on the financial statements for future reporting periods,
- concealing profit changes or other trends, especially in the context of general economic and industry conditions,
- impact on the ratios used to assess the entity's financial position, operating results or cash flows,
- an increase in executive compensation, for example, by causing the requirements for bonuses or other incentives to be met,
- significant contingent liabilities,
- related party transactions,
- estimates or uncertainties that may involve significant subjectivity,
- management's biased approach to maximizing or minimizing income,
- management's reluctance to correct reported weaknesses in internal control over financial reporting,
- vulnerability to losses due to errors or fraud.

A quantitative approach to materiality

ISA 320. A4 - A5 contain key information from the point of view of the methodology for determining materiality, namely

a) A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole;

b) Examples of benchmarks that may be appropriate, 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;

c) Additionally, paragraph A4 indicates examples of factors that may affect the choice of a particular benchmark that is the basis for calculating materiality.

ISA 320 therefore requires that in determining materiality, the auditor, after first considering factors relevant to the audited entity, including the needs of users of the financial statements, should choose to base the materiality calculation on a specific benchmark (for example: gross profit, total revenue or net assets).

The Agency notes that the public interest - i.e., accountability, integrity and ensuring effective legal oversight - should particularly influence the auditor's assessment of whether an item is material by its nature. This is particularly true for items that demonstrate compliance with laws, regulations or other reliable sources (ISA450.A25).

The auditor's determination of the level of materiality or the financial statements as a whole, performance materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the financial statements is an extremely important activity performed in the planning phase and verified during the audit of the financial statements, which has an enormous impact on the type of opinion issued. Correct determination of the materiality level makes it possible to distinguish material from not material misstatements. In doing so, attention should also be paid to considering the possibility of fraud in the audited financial statements already at the planning stage, when determining materiality and audit risk.

Most common inspection findings regarding materiality determination

1. Determination of overall materiality based on a combination of several benchmarks

Determination of materiality based on a combination of several benchmarks (for example, the arithmetic average calculated from: total assets, sales revenues and gross profit) should be considered non-compliant with ISA. Clear guidance in this regard is provided by ISA.320.A4 explaining how to identify a specific benchmark for determining materiality. This is also reflected in the results of the study, conducted by CEAOB in 2020 - 2021, the results of which were published in September 2022. In CEAOB's analysis, in none of the 495PIE's audited financial statements reviewed, was materiality determined based on a benchmark constructed from a combination of several financial statement items.

2. Determination of materiality by member of the engagement team other than the engagement partner. Adopting a single benchmark and percentage to determine materiality in the audit firm's methodology.

The determination of materiality is a matter of auditor's professional judgment (ISA320.4). Professional judgment is an attribute of the engagement partner. This means that the ISA leaves the act of determining materiality solely to the engagement partner. It is therefore considered incorrect for a member of the engagement team who is not an engagement partner to determine materiality.

It is also unacceptable for an audit firm to indicate in the audit methodology a single, specified benchmark for determining materiality, e.g. of total assets, as the only possible option for the auditor to use for auditing the financial statements.

It should also be considered incorrect for the audit firm to set a single specified level of percentage for determining overall materiality in the audit methodology for the auditor to accept for the audit of the financial statements.

It is also unacceptable for an audit firm to indicate in the audit methodology only one specific level of percentage for determining performance materiality as acceptable to the auditor for auditing the financial statements.

3. Lack of documentation regarding considerations in benchmark selection and factors affecting overall and performance materiality

Professional judgment expressed during the audit must be adequately documented (ISA200.A29). The need to adequately document materiality is clearly emphasized in ISA 320.14, according to which the audit documentation must contain not only the amounts of overall and performance materiality, but also the factors that were considered by the auditor in determining them. In the context of the requirements cited above, it should be considered incorrect to include in the audit documentation only the amounts of overall and performance materiality and the calculations that led to them. The audit file should also include justification for the benchmark selected by the auditor, based on which materiality was determined. The justification should be derived from the auditor's analysis of the factors that may affect the identification of the material benchmark, contained in ISA 320.A4 and other factors material to the audited entity. In addition, the auditor should include in the audit documentation a justification for the percentages used to calculate overall and performance materiality. This justification should be based on an analysis of the factors relevant to each type of materiality being determined.

4. Inappropriate factors adopted to determine overall materiality level

It is worth reminding, that that overall materiality refers to the needs of users of the financial statements, not to the level of audit risk. In turn, it is the determination of performance materiality that should be based on factors relating to audit risk. Therefore, the rationale in the audit file for adopting a certain level of percentage to determine overall materiality based on an analysis of factors such as:

a) the results of the risk assessment procedures carried out,
b) the nature and extent of misstatements identified during previous audits,
c) the auditor’s expectations in relation to misstatements in the current period,

should be considered incorrect (ISA 320.A13).

5. Failure to base further audit procedures on the determined level of materiality

The Agency draws attention to a finding appearing in the inspected audit file, which is failure to base further audit procedures on the determined materiality level. Meanwhile, ISA320 clearly indicates that materiality is taken into account throughout the audit (ISA320.A1), and the auditor determines performance materiality to estimate the risks of material misstatement and to determine the type, timing and extent of further audit procedures (ISA320.11). Therefore, it is incorrect, for example:

a) to exclude materiality as one of the primary criteria for determining material transactions, account balances and disclosures, for which the auditor is then required to perform substantive procedures in accordance with ISA330.18,
b) failure to consider materiality in selection of items for testing, including sampling.

6. No determination of threshold above which misstatements cannot be regarded as clearly trivial to the financial statements

In addition to determining overall and performance materiality, ISA require the auditor to set a threshold **above which misstatements cannot be regarded as clearly trivial to the financial statements** (ISA 450.5 and A3). ISA 450.5 in fact implies the auditor's obligation to collect misstatements identified during the audit other than those clearly trivial. The auditor's failure to determine the level of „trivial threshold” results in inability to identify misstatements other than those considered obviously not material, which, taken together, may cause a material misstatement of the financial statements. Thus, it should be concluded that failure to determine the level of "trivial threshold" and the key auditor's collection of misstatements above the level of "trivial threshold" significantly increases the risk of issuing an incorrect opinion on the audited financial statements.

Notes on determining materiality when auditing financial services entities

The Agency pays special attention to the specifics of auditing financial statements of financial services entities. Guidance in this regard is provided by ISA320.A3, which mandates that the determination of materiality be guided by law, regulations or other reliable sources, as well as the information needs of legislators and the public.

In the case of an audit of a financial market entity, the auditor's responsibility under laws, regulations or other reliable sources to report on specific matters, including, for example, fraud, may also affect the assessment of whether the misstatement is material (ISA450.A24).

The Agency draws attention to an anomaly which very often appears in audit files, consisting in the key auditor's adoption of a materiality benchmark based on total assets in the case of audit of financial statements of credit institutions (banks and cooperative savings and loan associations). Such a benchmark does not meet the requirements of ISA 320.4 including the guidance of ISA 320.A3.

Considering the legal requirements for banks, the basic parameter used by the legislator is equity. It appears in a number of requirements and indicators, for example:

a) minimum amount and other requirements for initial equity,
b) obligation to have own funds adapted to the size of its operations (Articles 126 and 128(1) of the Law of August 29, 1997. Banking Law),
c) the requirement to develop and implement strategies and procedures for estimating and maintaining internal capital on an ongoing basis, while these strategies and procedures, should be: effective, comprehensive, adequate to the nature, scale and complexity of the bank's operations - the bank reviews them regularly (Article 128 (1a), (1b) and (2) of the Banking Law),
d) restrictions on granting of a loan, cash loan, bank guarantee or surety to a member of the bank's board of directors or supervisory board, or to a person holding a managerial position (25% of the Tier 1 capital referred to in Article 5 of Regulation No. 575/2013) (Article 79a of the Banking Law).

The purpose of banking supervision, according to the law, in addition to ensuring compliance of banks' activities with the relevant legal regulations, is to ensure the safety of funds collected in bank accounts (Article 133(1) of the Banking Law). This objective is directly related to the bank's equity.

Regulations on the tasks performed by the Polish Financial Supervisory Authority in supervising the financial market indicate the importance of the bank's capital, for example:

a) Assessment of the level of capital covering the risks arising from the bank's activities performed as part of the bank's supervisory examination and evaluation, which is carried out at least once a year (Article 133a of the Banking Law),
b) Activities undertaken as part of banking supervision, consisting in particular of assessing the financial condition of banks, including the solvency test (the ratio of a bank's net equity to the value of risk-weighted assets and off-balance sheet items) (Article 133(2) of the Banking Law),
d) Examination of compliance with the limits referred to in Article 79a of the Banking Law and Article 395 of Regulation No. 575/2013, and evaluation of the process of identifying, monitoring and controlling concentration of exposures, including large exposures. These limits relate to equity (Article 133(2) of the Banking Law),
e) Assessing the estimation, maintenance and review of internal capital (Article 133(2) of the Banking Law).

In addition, provisions related to the threat of a bank's bankruptcy or lack of indications that supervisory action can be taken, or lack of indications that the bank's actions will remove the threat in a timely manner, indicate the importance of equity, as the FSC, in making the assessment in question, takes into account in particular (Article 101 (5) of the Act of June 10, 2016 on the Bank Guarantee Fund, the deposit guarantee system and forced restructuring):

a) Violation or threat of violation of the entity's own funds, liquidity and leverage requirements;
b) Assessment of the entity as a result of the audit and supervisory assessment indicating an unfavorable financial situation of the entity (with this assessment, equity is also important);
c) Loss or risk of loss materially affecting own funds;
d) Violation of the Fund's specified minimum level of own funds and bail-inable liabilities;
e) The conduct of activities by the entity in violation of the law or the Articles of Association, which may lead to the insolvency or loss of liquidity of the entity.

ISA 320.2-4 indicates that in determining materiality, the basis for its determination should be the impact on economic decisions made by users based on the financial statements. In the case of an audit of a bank's financial statements, both from the point of view of the owners, the regulator and especially the bank's customers, the basic parameter of their interest is the safety of funds, including solvency of the bank and stability of its operations. An example of a benchmark that meets these prerequisites is equity or gross profits or profitability ratios. It is therefore not the total assets, which is often the measure adopted by key auditors to estimate materiality.

The Agency notes that the materiality benchmark used in the audit of banks' financial statements, based on total assets as a consequence, meant that on more than one occasion a key auditor was able to accept a misstatement in the financial statements (without modifying the opinion), the value of which was even above 100% of total equity.

The above-described considerations regarding the erroneous adoption of total assets as a benchmark for determining materiality also apply to the audit of the financial statements of cooperative savings and loans associations (‘’SKOKs”).

When auditing the financial statements of ‘’SKOKs”, both from the point of view of the owners, the regulator, and especially the beneficiaries (members) of the cooperative savings and credit union, the basic parameter of interest is, as in the case of banks, the security of funds, including solvency of the SKOK and the stability of its operations, i.e. also in this case the basic parameter is not the total assets.

Referring again to the **CEAOB's 2020 - 2021 survey**, published in September 2022, it should be pointed out that the most popular benchmark, in 21 EEA countries, for determining materiality in credit institutions was equity, followed by gross profit. Total assets were used in only 13% of cases. In contrast, the Audit Committees of the 495entities surveyed in no case pointed to total assets as the benchmark suitable for determining materiality in credit institutions. Profitability ratios were most often indicated as a benchmark (29%).

PANA recalls that the purpose of an audit is to express a reasonable opinion with a high level of assurance as to whether the audited financial statements are free from material misstatement whether due to fraud or error. The Agency notes that a correct determination of materiality affects the entire course of the audit and underpins the correctness of the auditor's expressed opinion. PANA also reminds that in assessing the impact of misstatements on the financial statements, the nature of the misstatements and the circumstances under which they occurred should also be considered.