

In addition, materiality is not just a purely financial concern. Disclosures in the financial statements relating to possible future legal claims, for example, could influence users' decisions and may be purely narrative. In this case a numerical calculation is not relevant.

## MATERIALITY

### Material by nature or impact

Examples of items which are material by nature or material by impact include:

- Misstatements that, when adjusted, would turn a reported profit into a loss for the year.
- Misstatements that, when adjusted, would turn a reported net-asset position into a net-liability position (or net-current asset to net-current liability)
- Transactions with directors, e.g. salary and benefits, personal use of assets, etc.
- Related party transactions.

### Illustration 2: Murray Co materiality

\$000

#### Financial Statement Extracts

	2012	2011
Revenue	21,960	19,580
Total assets	9,697	7,288
Profit before tax	1,048	248

#### Materiality

##### **Revenue**

	<u>1/2%</u>	<u>1%</u>
2012	110	220
2011	98	196

##### **Profit before taxation**

	<u>5%</u>	<u>10%</u>
2012	52	105
2011	12	25

##### **Total assets**

	<u>1%</u>	<u>2%</u>
2012	97	194
2011	73	146

A suitable range for **preliminary materiality** is **\$97,000 - \$105,000**.





### Murray Co materiality

Materiality is not normally based on revenue, except in circumstances when it would not be meaningful to base materiality on profit, e.g. because the entity being audited is a not-for-profit entity or where there is a small profit (or a loss) as this will result in over-auditing of the financial statements (such as was the case for Murray Co in 2011).

More than \$105,000 profit is material to the statement of comprehensive income, therefore preliminary materiality is likely to be set so as not to exceed this amount. Less than \$52,000 is not material to profit (or to the statement of financial position) so preliminary materiality should not be less than this amount.

A suitable preliminary materiality level is most likely to be one that lies within the overlap of the ranges calculated for profit and total assets. \$97,000 (1% of total assets) represents 9% profit. As this is at the lower end of the assets range, this would be a relatively prudent measure of materiality (resulting in a higher level of audit work).

\$105,000 (10% of profit) represents 1.1% of total assets. Preliminary materiality might be set at this end of the range had this been a recurring audit. However, as this is a first audit, preliminary materiality is likely to be lower.

The financial statements are draft and therefore greater errors should be expected than if they were actual. Consequently, sample sizes for audit testing should be increased (i.e. preliminary materiality should be set at a relatively lower level).

Preliminary materiality is therefore likely to be set at \$97,000.

### The practical application of materiality

It is unlikely, in practice, that auditors will be able to design tests that identify individually material misstatements. It is much more common that misstatements in aggregate (i.e. in combination) are material.

Auditors also only test on a sample basis, so they have to evaluate their findings and determine how likely it is that errors identified in the sample are representative of material errors in the whole population under scrutiny (i.e. projected misstatements).

Materiality, as determined for the financial statements as a whole, may not be the best guide in determining the nature and extent of audit tests. For this reason, ISAs introduce a further concept: **performance materiality**.



**Performance materiality** is defined in ISA 320 as:



'The amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.'

- The auditor sets **performance materiality** at a **value lower than overall materiality**, and uses this lower threshold when designing and performing audit procedures.
- In using this lower threshold, the auditor is more likely to identify misstatements.
- This **reduces** the **risk** that the auditor will fail to identify misstatements that are material in combination.



#### **Murray Co performance materiality**

The audit engagement team has planned the audit of the financial statements for the year ended 31 December 2012. The team has determined a materiality level for the financial statements as a whole, of \$97,000. Performance materiality needs to be applied to work-in-progress inventories, as this is an area of audit risk.

Performance materiality could be determined as a percentage of financial statement materiality, say 75%, i.e. a performance materiality of (\$97,000 × 75%) \$72,750 (the audit team could use a higher or lower percentage, or use a different calculation, depending on their professional judgement).

The aim of performance materiality is to reduce the risk that the combination of immaterial misstatements exceed materiality for the financial statements as a whole.

For example, if a misstatement was identified of, say \$80,000, without performance materiality the auditor would conclude that work-in-progress is not materially misstated. However, the audit may not have detected further misstatements which when added to the \$80,000 identified would result in a material misstatement. By using performance materiality, the auditor would conclude that a misstatement of \$80,000 is material, and consequently would require the directors to amend the financial statements to correct this misstatement, reducing the risk of giving an inappropriate opinion.