



## Article topic: Financial Reporting

# Performance Materiality: How to Apply

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The new Clarified ISAs, which are effective for the audit of financial statements for accounting periods commencing on or after 15 December 2009, will shortly start to bite (that is for those practitioners who have not adopted the new ISAs early).

Before Christmas, I was lecturing to members of the Society of Professional Accountants (SPA) on how the new ISAs will affect their audit staff, or their practice if they are a sole practitioner. One question which was asked of me both during the lecture and in the break concerned the issue of 'performance materiality' and seemed to confuse practitioners.

Performance materiality is a new concept, borne out of the International Auditing and Assurance Standards Board (IAASB) Clarity Project. Audit materiality is certainly not a new concept and auditors have always had to (and will continue to) arrive at a materiality level where an audit opinion is expressed. The confusion (at the present time) lies within performance materiality.

ISA 320 defines performance materiality as:

*'the amount(s) 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 and the amount(s) set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances or disclosures.'*

### **'Traditional' materiality**

Auditors have always calculated materiality at the planning stage of the audit, and this is set to continue under the new standards. However, we now have two standards which deal with materiality – that of ISA 320 *Audit Materiality* and that of ISA 450 *Evaluation of Misstatements Identified During the Audit*. It is important at the outset to understand that materiality calculated at the planning stage of the audit may not, necessarily, remain static throughout the course of the audit. Indeed matters may be discovered during the course of the audit which may require the auditor to revise the original materiality level. ISA 450 requires the auditor to evaluate the effect of any identified misstatements on the financial statements in order to form an opinion as to whether the financial statements, as a whole, are free from material misstatement.

There are instances where the auditor may discover transactions which, in themselves, may be immaterial in terms of quantity, but become material by their nature. Consider the following example:

### **Figure 1**

Company A Ltd has been an audit client of yours for several years. Over the last 5 years they have been making recurring losses and you are auditing the financial statements for the year ended 31 July 2010 which show a pre-tax profit of £15,000. You have determined a financial statement materiality level of £40,000.

During the course of your audit you have discovered a supplier invoice amounting to £30,000 which was received on 1 September 2010 but related to supplies received by Company A on 29 July 2010 and has been dated 31 July 2010. The invoice has not been provided for in the financial statements.

You can see that Company A's £15,000 profit would turn into a £15,000 loss if this invoice is not adjusted for in the financial statements, despite it being under the original materiality level calculated at the planning stage. The fact that this would completely change the picture presented in the financial statements would mean this should be adjusted for as it is material by nature.

### **Old versus new**

The old standards (as do the new ones) recognise the requirement to continue to calculate a materiality level at the planning stage of the audit. Under the old ISA 320, the auditor may well have considered applying a different materiality level (i.e. a lower level) to the more risky areas of the financial statements – though I suspect this would have been applied only in rare situations with the materiality level calculated at the planning stage being the benchmark.

The new standard recognises that there could well be instances where certain classes of transactions, account balances or disclosures might be affected by misstatements which are less than the materiality level for the financial statements as a whole, but which may well influence the decisions of the user of those financial statements regardless of the fact they are below materiality – this is where performance materiality is to be applied. Specifically, the clarified ISA 320 suggests performance materiality be applied to areas such as related party transactions and directors' remuneration. However, the clarified ISA requires performance materiality to be set to areas of the financial statements which could reasonably be expected to influence the economic decisions of users. Figure 2 shows how this could be applied in the area of intangible fixed assets.

### **Figure 2**

Company B Limited operates in the pharmaceutical industry developing drugs for medical conditions and as such has a significantly high level of research and development expenditure (assume for the purposes of this illustration Company B reports under UK GAAP and, thus, SSAP 13 *Accounting for Research and Development* is pertinent).

The audit engagement team has planned the audit of the financial statements for the year ended 31 December 2010 and auditing under the clarified ISAs. The firm has determined a materiality level for the financial statements, as a whole, of £90,000 which has been calculated using the

traditional 'averaging' method (1% of turnover, 2% gross assets and 10% profit before tax). Recently there has been a lot of interest by potential investors and initial talks have been entered into by potential investors to purchase the company due to its reputation. The potential investors are particularly interested in the results of the audited financial statements as at 31 December 2010.

The draft financial statements show that capitalised development expenditure has a net book value of £2,500,000 which is clearly material to the financial statements. However, the audit engagement partner has emphasised the point that he is aware the directors are keen to capitalise as much development expenditure as possible in order to boost the balance sheet and has therefore advised the audit engagement team to apply performance materiality to the development expenditure. This is because SSAP 13 suggests only development expenditure which meets the recognition criteria can be capitalised – any expenditure which does not meet the recognition criteria is written off to the profit and loss account as incurred (because it is classified as research expenditure), hence there is a risk of material misstatement within the area of research and development.

The problem with performance materiality is that it is based on professional judgement. There is no guidance in the clarified ISA 320 as to how to calculate it. The clarified ISA does, however, refer to the use of benchmarks in establishing materiality but it emphasises the point that materiality, in all instances, is a matter of professional judgement.

In the case of the scenario in Figure 2, performance materiality needs to be applied to an area which could influence the economic decisions of the user of Company B's financial statements (i.e. potential investors). Performance materiality could well be determined as a percentage of financial statement materiality, say, 60%. As a result, a performance materiality of (£90,000 x 60%) = £54,000 could be set for the audit of research and development expenditure. The auditor could set higher or lower percentages, or even come up with a more complex formula, depending on their professional judgement, and factors which affect this professional judgement are discussed below.

### **The objective**

The clarified ISA recognises that planning the audit solely to detect individually material misstatements does not take into consideration the fact that individually immaterial misstatements may also cause the financial statements to be materially misstated. The aim of performance materiality, therefore, is to further reduce the probability that the uncorrected misstatements (in totality) exceeds financial statement materiality (i.e. its intention is a 'catch all' materiality).

The clarified ISA also goes on to confirm that there is no set calculation to arrive at a performance materiality level – this is purely left to the auditor's professional judgement and is affected by issues such as:

- the auditor's understanding of the entity;
- experience in prior year audits;
- nature and extent of misstatements identified in prior year audits;
- auditor's expectations in the current year; and
- the risk assessment.

## **Conclusion**

The concept of performance materiality does seem to have thrown confusion amongst professional auditors and because there is no guidance on how auditors should calculate it, it does seem to be a very grey area – but we must not forget that auditing (and accounting) is an art, not a science, therefore professional judgement is a crucial aspect of our work. As the concept becomes more established, standard setters, software providers and professional CPD providers could well come up with calculations on how to arrive at performance materiality. I suppose back in the days when the concept of materiality was first introduced, auditors then had the same issues we face now with performance materiality.

Auditors using the clarified ISAs must not forget that financial statement materiality, calculated as a whole, must be reconsidered where the auditor (or audit team) become aware of matters which would have changed the initial materiality had the matter(s) been known at the planning stage of the audit. In addition, where a lower level of materiality is required, the auditor must also consider whether performance materiality should also be revised which would then result in additional audit procedures being undertaken.

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