



Financial Reporting Council

# AUDIT QUALITY THEMATIC REVIEW MATERIALITY

DECEMBER 2017

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Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

# Financial Reporting Council

## Audit Quality Thematic Review

### Materiality

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# 1 Background, scope and key messages

## 1.1 Background

Auditors, in reaching their opinion as to whether financial statements are true and fair, assess the risk and evidence of material misstatement and/or omission. Auditing standards define information to be material if its misstatement individually or in aggregate could influence the economic decisions of users. Materiality is thus assessed quantitatively and qualitatively.

In future, with technological advances, the importance of materiality may reduce as companies and their auditors become able to more cost-effectively, and accurately, interrogate and adjust financial information. However, this is not yet the case.

Today, the assessment of materiality drives the scope, nature and extent of the auditor's work. The determination of quantitative and qualitative materiality affects audit quality.

We issued a thematic review on materiality in 2013. Since then we have seen a number of changes take hold in the UK audit market, including:

- the requirement for FTSE 350 companies to conduct a tender at least once every ten years and now for Public Interest Entities<sup>1</sup> (PIEs) to rotate auditors after twenty years;
- an enhanced role for audit committees in auditor appointments ensuring the ongoing independence and quality of the audit; and
- extended auditor reporting requiring enhanced disclosures, including the materiality threshold used by the auditor and how the auditor applied it.

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<sup>1</sup> Public Interest Entities are:

(a) An issuer whose transferable securities are admitted to trading on a regulated market;

(b) A credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council, other than those listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms;

(c) An insurance undertaking within the meaning given by Article 2(1) of Council Directive 1991/674/EEC of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertakings. No other entities have been specifically designated in law in the UK as 'public interest entities'.

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This review explains the concept of audit materiality and how the major firms determine materiality in practice<sup>2</sup>. We have grouped our findings:

- Audit firms – to enhance their methodology and guidance, application in practice and communication and reporting.
- Audit Committees and their chairs (ACCs) – to assist them in understanding of the impact of materiality assessments on the audit process and their challenge of auditors.
- Investors and the public at large – for them to obtain an insight into what audit materiality is and how it is used, to help address one of the expectation gaps related to audit and ensure that maximum benefit is obtained from the increased transparency in audit reports.
- Auditing standard setters – we identify where it would be helpful to consider providing additional guidance to aid auditors and other stakeholders.

## 1.2 Scope

We visited eight audit firms to discuss the concept of materiality and review their related audit methodology and guidance. We also reviewed relevant aspects of the procedures performed on the audit of 32 entities in a variety of sectors. The entities we selected were PIEs (with year ends from 31 March 2016 to 31 January 2017) and we obtained copies of the relevant working papers from the most recent audit file. Where possible we included a loss-making entity and a first year audit in the selection for each firm to determine the impact of these two factors in the materiality judgments. The principal results and our key findings are set out in Section 3.

In view of the critical importance of audit materiality and the impact that it has on audit planning, scoping, execution and reporting, we extended beyond the scope of our 2013 review, to gather the views of ACCs and of investors. We held discussions with a sample of ACCs of PIEs across a variety of industries to:

- seek their views on audit materiality and
- understand their interaction with their auditors or prospective auditors on materiality at the planning and reporting stages of the audit and, where relevant, during the tender process.

Findings arising from these conversations and our observations on auditor communication with audit committees are summarised in Section 4.

The FRC hosted a roundtable with investors to understand views on audit materiality and whether it informs their investment decisions. Attendees included individuals within research, corporate governance analysis and business managers from a number of investment houses. A summary of their views and implications for the audit firms and audit committees are set out in Section 5.

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<sup>2</sup> The audit firms included within this review were BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP, Mazars LLP, Moore Stephens LLP and PwC LLP.

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We considered how:

- materiality is assessed across the financial statements as a whole (overall materiality);
- the auditor reduces to an appropriately low level the probability that the aggregate of misstatements identified through their audit work exceeds overall materiality (performance materiality);
- materiality is assessed for entities or business activities included within the financial statements (component materiality); and
- materiality is assessed for particular classes of transactions, account balances or disclosures (also performance materiality).

### **1.3 Key findings and messages for audit firms**

We are pleased that the majority of the key messages for audit firms in our last report have been addressed by the firms. These include an increase in the emphasis within the firms' methodologies on the application of judgment when determining overall materiality and performance materiality; providing industry-specific guidance for many sectors and demonstrating the consideration of risk in setting performance materiality.

Three of the audit firms have introduced guidance to encourage audit teams to reduce performance materiality to reflect the increased risk of first year audits.

Audit teams should ensure that if adjusted profit is used as a benchmark, it is a true reflection of the needs of users of the financial statements. If adjusted profit is used, auditors should explain why they have made the adjustments and how the benchmark selected better responds to the needs of the users of the financial statements.

Audit firms should provide audit teams with guidance on setting component materiality, including both how to address the relative sizes of components and the particular risks arising in certain components.

Audit firms should consider how they can better explain the concept of performance materiality in their reports. As one of the influences on performance materiality is the auditor's view of the control environment at the entity, the difference between overall materiality and performance materiality can give investors some insight into this area.

### **1.4 Key findings and messages for audit committees**

Our previous report also contained messages for audit committees. Requirements for audit committees of PIEs have moved on since our 2013 report, but the list of factors included in that report to consider when discussing materiality with the auditors remains relevant. We have repeated them, together with the additional messages from this report, in Appendix 1. Our 2013 thematic review can also be found here:

[http://www.frc.org.uk/getattachment/e8f4d3ae-92ea-4d62-a997-2c670454d8ab/FRC-AQTR\\_Materiality-Dec-2013.pdf](http://www.frc.org.uk/getattachment/e8f4d3ae-92ea-4d62-a997-2c670454d8ab/FRC-AQTR_Materiality-Dec-2013.pdf)

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Audit Committees should understand and challenge the judgments underlying the setting of materiality and how it affects the audit work performed. A number of ACCs noted that when considering the appropriateness of the materiality set by their audit team, they would review the materiality levels disclosed in audit reports of similar (competitor) entities.

We also noted an example of an ACC requesting that overall materiality should be decreased from the level originally proposed by the audit team.

Audit Committees should ensure that component materiality is properly explained and justified to them by the auditor.

Audit Committees should consider how best to engage with investors on materiality and adjusted and unadjusted differences. They should also ensure that their own reporting provides sufficient information on the discussions held with auditors regarding these differences.

## **1.5 Considerations for standard setters**

Standard setters should be aware of the recent developments in the practice of setting materiality, including the use of forecasts (profits, equity and net assets) as benchmarks. Using forecasts as a benchmark may be appropriate in certain circumstances, but auditors are likely to benefit from some guidance in this area including an indication of the industry sectors in which it is most likely to be appropriate. This will become even more relevant when accounting for expected credit losses applies, as volatility in profits may initially increase along with the use of forecast information.

Standard setters should consider whether auditors would benefit from guidance regarding setting component materiality and how it relates to overall materiality and the impact that it has on the audit work performed. A number of audit firms do not provide such guidance to their audit teams, which leads to inconsistencies in practice, both within and between firms.

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## 2 Materiality and market analysis

### 2.1 What is materiality?

In accordance with International Standards on Auditing (UK) ('Auditing Standards'), information is considered to be material if its misstatement or omission individually or in aggregate could influence the economic decisions of users on the basis of the financial information provided. Setting materiality is recognised by standard setters and auditors as a key part of the audit from which the planning, scoping and reporting flows. With future technological advances, the importance of materiality may reduce as companies and auditors become able to cost-effectively interrogate a higher proportion of transactions and make any necessary adjustments to financial statements without delaying or reducing the quality of financial reporting. However, this is not yet the case.

Materiality is considered both quantitatively and qualitatively.

Auditing standards explain that the auditor uses the concept of materiality in planning and performing the audit to detect material misstatements. Further, at the conclusion of an audit the auditor determines whether the uncorrected misstatements identified are individually or in aggregate material to the financial statements

Determining materiality involves the exercise of judgment, having particular regard to the common financial information needs of users of an entity's financial statements as a group.

A common approach is to start by applying a percentage to a chosen benchmark, such as profit before tax or net assets. Judgment is required in selecting both the appropriate benchmark for the entity and the appropriate percentage of this benchmark. Judgment may also be applied in adjusting the resulting amount to arrive at an appropriate final figure for materiality for the financial statements as a whole ('overall materiality'). While firms' policies constrain the judgments that individual audit partners and their teams may make, the setting of these policies itself reflects the application of judgment by experienced auditors within each firm. It is, however, the judgment exercised by an audit team, within the constraints set by their firm, that determines the final materiality level for any audit.

The judgments exercised by auditors in determining materiality should not, however, be restricted to quantitative considerations such as those outlined above. Qualitative factors relating to the needs and expectations of users of an entity's financial statements should be the overriding consideration.

The setting and application of materiality is part of the planning phase of the audit. However, Auditing Standards require overall materiality to be revised where there is a subsequent change in circumstances or the auditor becomes aware during the audit of relevant new information.



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Planning the audit solely to detect individually material misstatements would overlook the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Therefore, auditors also set 'performance materiality' as a basis for audit planning and testing.

The auditor uses performance materiality to assess the risks of material misstatement and determine the nature, timing and extent of audit procedures. Auditing Standards indicate that auditors should exercise professional judgment in setting performance materiality. This judgment is affected by the auditor's understanding of the entity including the quality of the internal control environment and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Performance materiality affects the amount of audit work performed in a number of ways. Performance materiality is used to scope areas of the financial statements and business and activities ('components') of groups that will be subject to audit. It is also used in determining statistical sample sizes and whether variances arising from analytical procedures should be investigated. Auditors' materiality judgments are therefore often key factors in determining the amount of audit work performed and the level of detail at which work is performed.

Auditors are required to accumulate all unadjusted misstatements assessed as not 'clearly trivial' and to request management to correct them. Any uncorrected misstatements are to be reported to the Audit Committee, requesting that they be corrected and stating the potential implications for the audit report. Material uncorrected misstatements are to be identified individually.

In the UK auditors issuing extended audit opinions disclose in those reports the materiality adopted in their audit.

## **2.2 How do auditors determine materiality?**

Determining materiality is a key judgment for the auditor. All firms highlight the importance of judgment in their methodologies and encourage audit teams to apply judgment to their materiality assessments. Audit teams consider the needs of the users of an entity's financial statements as a group when determining the appropriate benchmark on which to base their materiality calculations.

Audit firms use a number of different benchmarks as a basis for their calculation of materiality. Examples include:

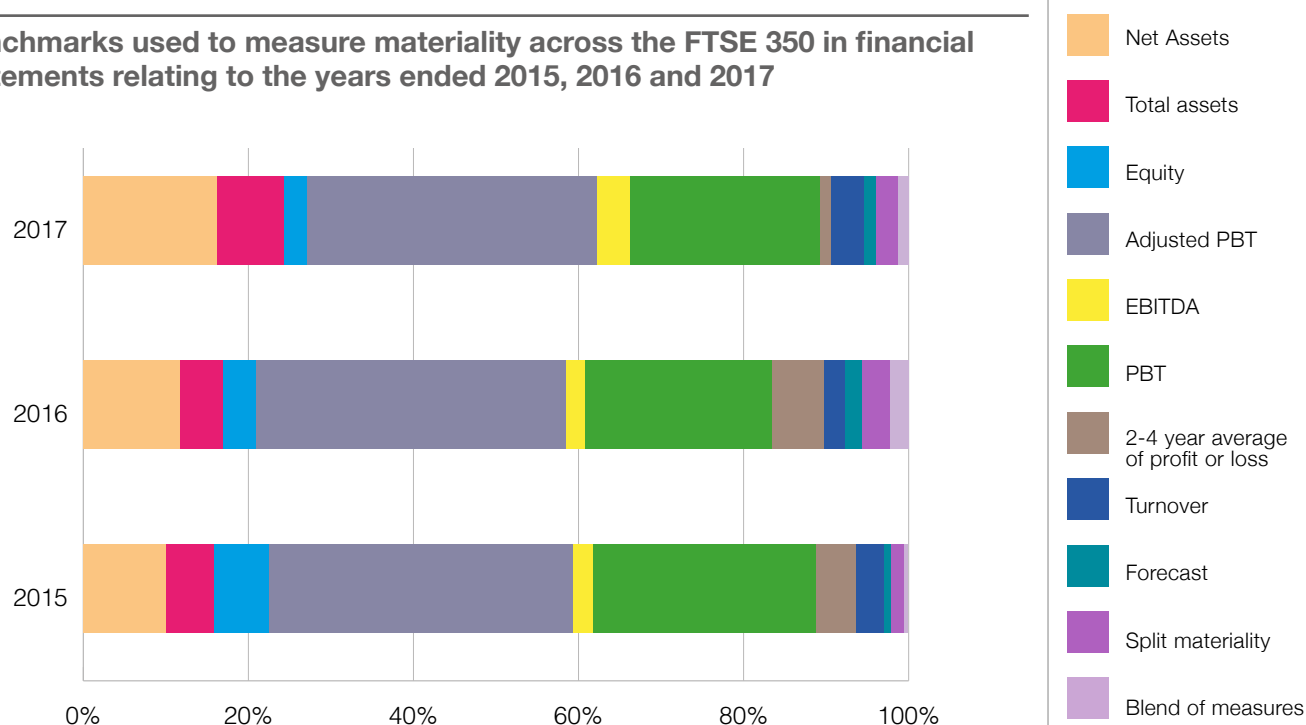
- profit related measures, which may be adjusted for various items (for example, acquisition costs, refinancing costs, amortisation and impairment);
- revenue;
- asset measures (total or net); and
- equity.

Section 3.2 includes a summary of the firms' quantitative guidance in relation to various benchmarks.

### 2.3 What materiality benchmarks do we see in practice?

The graph below shows, in percentage terms, how the various benchmarks for materiality were used by auditors in the audit of FTSE 350 entities in the period 2015-2017. In all three years, auditors used a profit-related benchmark in a majority of cases. However, between 2015 and 2017 there has been an increase in the number of audits where materiality has been based on an asset measure (net or gross) and a fall in those calculating materiality using equity.

**Benchmarks used to measure materiality across the FTSE 350 in financial statements relating to the years ended 2015, 2016 and 2017**



There continue to be more cases where auditors base materiality on an adjusted or normalised profit measure than those calculating materiality based on a financial statement profit measure. When selecting the appropriate benchmark to be used, auditors should ensure that, if an adjusted profit measure is selected, it is appropriate for the users of the financial statements. Profit before tax is expected to be the main financial benchmark for most listed trading entities and so auditors should seek to understand any other adjusted performance indicator identified by an entity's directors and why the use of an alternative benchmark for determining materiality may be appropriate in a particular case.

We noted from our discussion with investors (Section 5) that their key profit measure often adds back non-cash items such as amortisation of intangible assets and impairment of goodwill. Auditing Standards expect adjustments to a profit benchmark to be as a result of an exceptional increase or decrease in profits, which appears to preclude such an adjustment. Further, 'exceptional' items in financial statements are often similar in nature from one year to another, for example an entity will record an impairment on an investment property or other tangible asset in one period and an impairment on a similar asset in the next period. In our view, adjusting a profit benchmark for these 'similar' impairments is

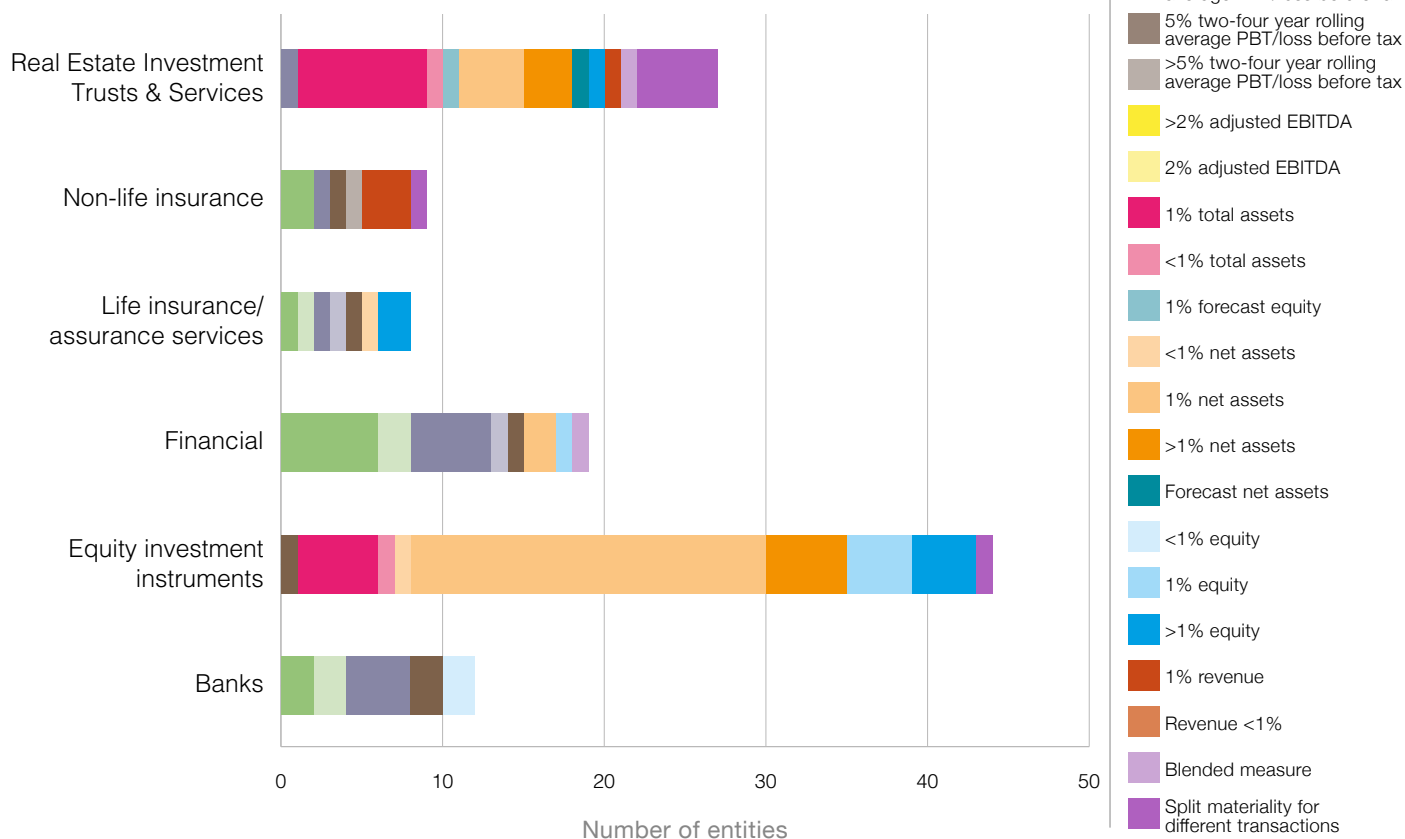
not appropriate, as they are a normal part of the business activities. However, adjusting a profit benchmark for a recurring item that leads to a benchmark better in line with what would affect the decisions of the users of the financial statements seems aligned with the standards. In such cases, explanations of the judgments made should be given to the Audit Committee and in the extended audit report.

## 2.4 What are the different approaches to setting materiality between industry sectors?

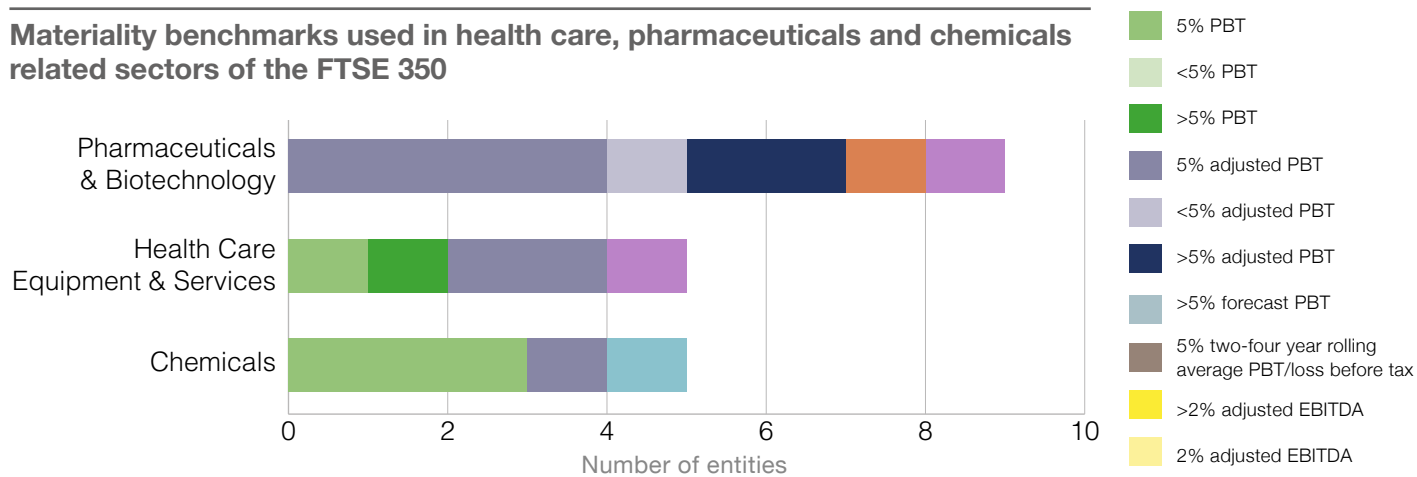
Graphs below demonstrate the wide variety of benchmarks used by auditors to determine materiality across the FTSE 350 entities, varying both between and within industry sectors. These graphs have been compiled using the most up to date published audit reports as at 30 June 2017.

It may be appropriate to use a profit based measure for some sectors, such as construction, general retailing and support services; in others, such as mining and equity investment instruments, however, earnings before interest, tax, depreciation and amortisation (EBITDA) and net asset values may be more appropriate. In some firms we reviewed good sector specific guidance produced to assist audit teams in selecting the most appropriate benchmark.

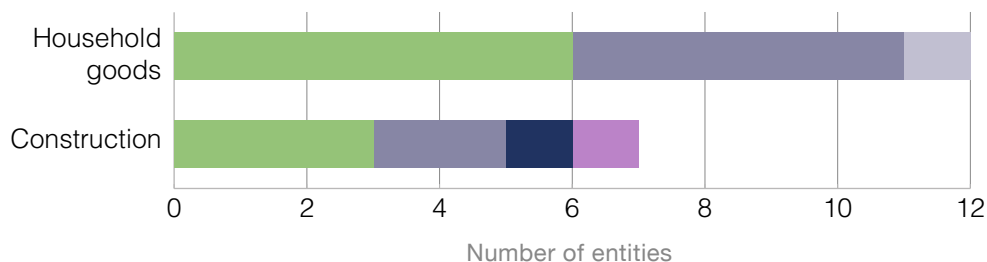
### Materiality benchmarks used in financial and insurance related sectors of the FTSE 350



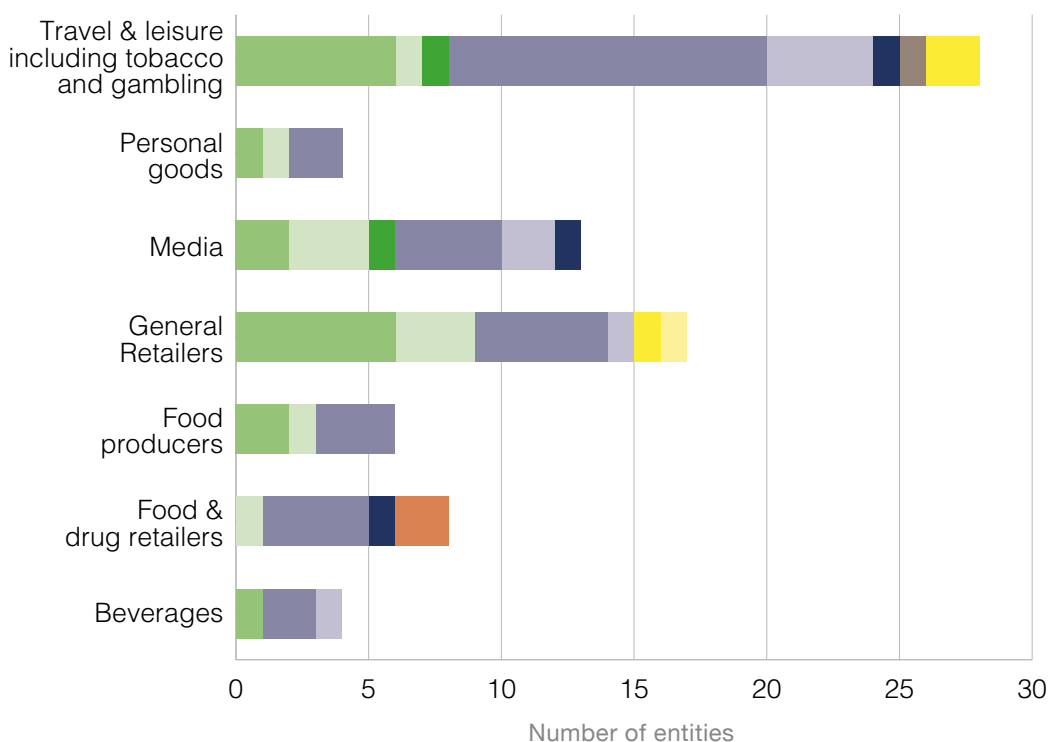
### Materiality benchmarks used in health care, pharmaceuticals and chemicals related sectors of the FTSE 350



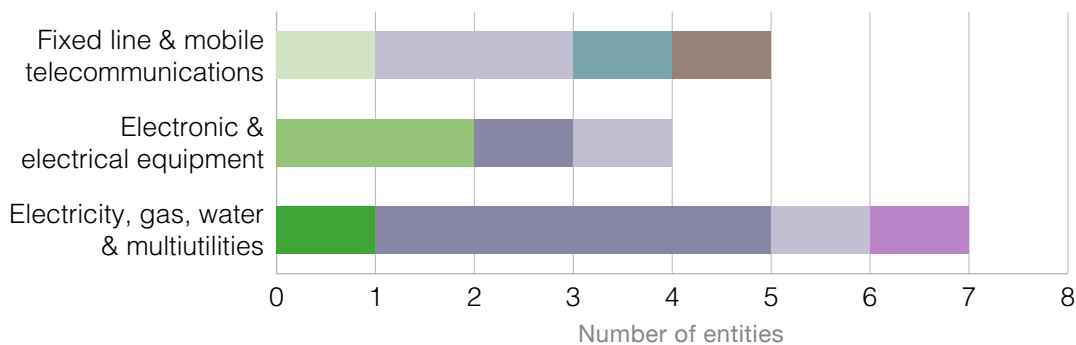
### Materiality benchmarks used in construction and household goods related sectors of the FTSE 350



### Materiality benchmarks used in beverages, food, media, personal goods and travel related sectors of the FTSE 350

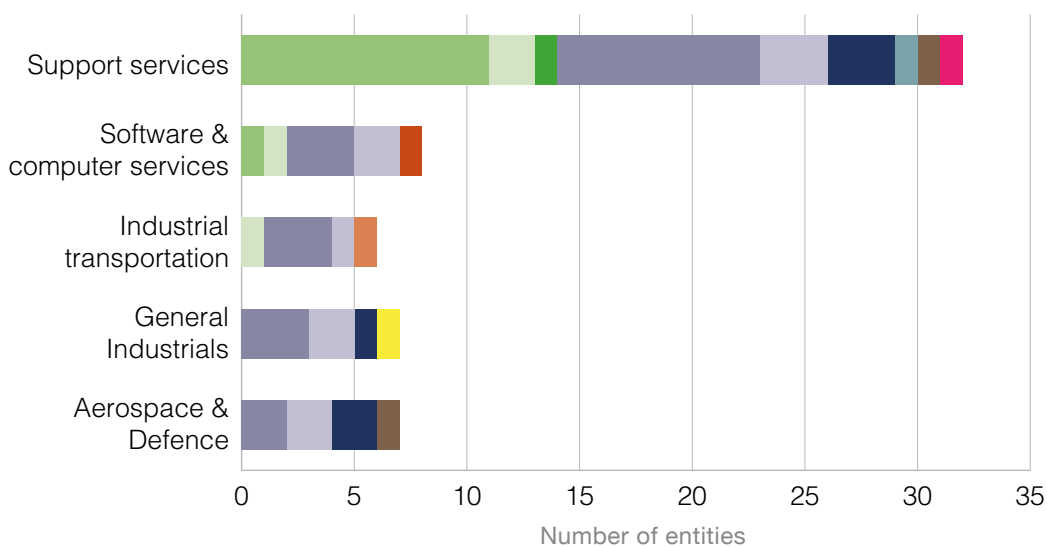


### Materiality benchmarks used in electrical, telecommunication and utilities related sectors of the FTSE 350



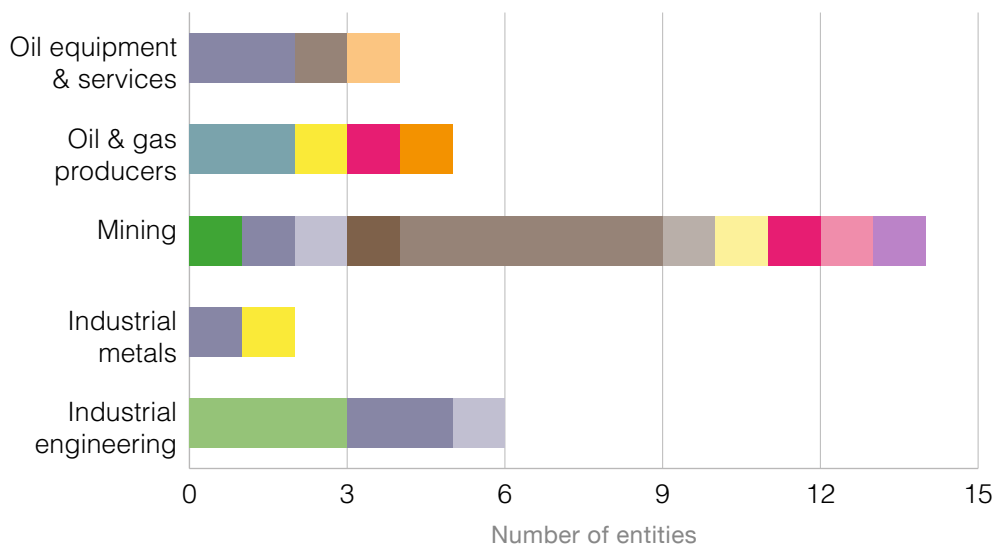
- 5% PBT
- <5% PBT
- >5% PBT
- 5% adjusted PBT
- <5% adjusted PBT
- >5% adjusted PBT
- 5% forecast PBT
- <5% two-four year rolling average PBT/loss before tax
- 5% two-four year rolling average PBT/loss before tax
- >5% two-four year rolling average PBT/loss before tax

### Materiality benchmarks used in support services, transportation, aerospace and defence and general industrials related sectors of the FTSE 350



- >2% adjusted EBITDA
- 2% adjusted EBITDA
- 1% total assets
- <1% total assets
- 1% net assets
- >1% net assets
- 1% revenue
- Revenue <1%
- Blended measure

### Materiality benchmarks used in industrial engineering, metals, mining and oil related sectors of the FTSE 350



Audit firms should continue to reassess the appropriateness of their materiality benchmarks and thresholds in light of changes in the market and the needs of stakeholders. They should explain the judgments made.

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## 3 Findings from our review – Audit Firms

### 3.1 Methodology and guidance

All the firms which we reviewed have a range of comprehensive and detailed guidance on overall materiality which covers the concept of audit materiality and emphasises the need to apply judgment. The guidance includes a range of percentages to be applied to a variety of benchmarks in order to make the judgments on overall materiality. Guidance on performance materiality, thresholds for reporting matters to Audit Committees (often termed the ‘clearly trivial’ threshold) and component materiality is less prescriptive and detailed; in some cases is left entirely to the judgment of the auditor.

All eight firms provide some industry specific guidance on appropriate benchmarks, with the industries covered by each firm largely reflecting their own sector specialisms. Guidance for the various types of entities in the financial services sector is provided by all the firms. We are pleased to note the attention and detail that goes into the firms’ methodology and to providing specific guidance for those industry sectors where the judgments involved may be more complex.

The table in section 3.2 summarises the quantitative guidance made available by the firms to audit staff in relation to the various overall materiality benchmarks.

### 3.2 Comparison of quantitative guidance

The firms’ methodologies typically provide little or no guidance on how to calculate materiality for loss making entities and we have raised this with the firms.

As can be seen from the tables, most firms have a range of percentages that can be used for each benchmark. Some firms use ranges that are more prudent than others. We consider the impact of these differences in the following sections.

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Audit firms should include guidance in their methodologies to audit teams regarding materiality judgments when an entity is loss making.

MEASURE	Firm A	Firm B	Firm C	Firm D	Firm E	Firm F	Firm G	Firm H
<b>Overall materiality</b>								
Profit/loss before tax (PIE)	5-10%	3-5%	5-8%	3-5%	5-10%	up to 5%	3-10%	5-10%
Profit/loss before tax (non PIE)	0-10%	3-10%	5-10%	3-10%	5-10%	up to 10%	3-10%	5-10%
Total revenue/expenses (PIE)	0.8-5%	0.25-2%	0.5-1%	0.5-1%	0.5-2%	up to 1%	0.5-2%	0.5-2%
Total revenue/expenses (non PIE)	0.8-5%	0.25-3%	0.5-2%	0.5-3%	0.5-2%	up to 2%	0.5-2%	0.5-2%
Net Assets/Equity (PIE)	0-3%	0.5-2%	1-2%	3-5%	1-5%	up to 1%	2-5%	3-5%
Net Assets (non PIE)	0-3%	0.5-3%	1-2%	3-10%	1-5%	up to 2.5%	2-5%	3-5%
<b>Performance materiality<sup>3</sup></b>	Max 70%	40-75%	50 or 75%	50-75%	50-80%	90 <sup>4</sup> , 75 or 50%	50-75%	40-75%
<b>Clearly trivial<sup>3</sup></b>	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%	0-5%
<b>Component materiality<sup>3</sup></b>	50-95%	60-90%	Based on the percentage of the overall threshold the component makes up	Professional judgment	Based on the percentage of the overall threshold the component makes up	Based on the percentage of the overall threshold the component makes up	No specified percentage range	Professional judgment

### 3.3 Impact of differences in quantitative guidance

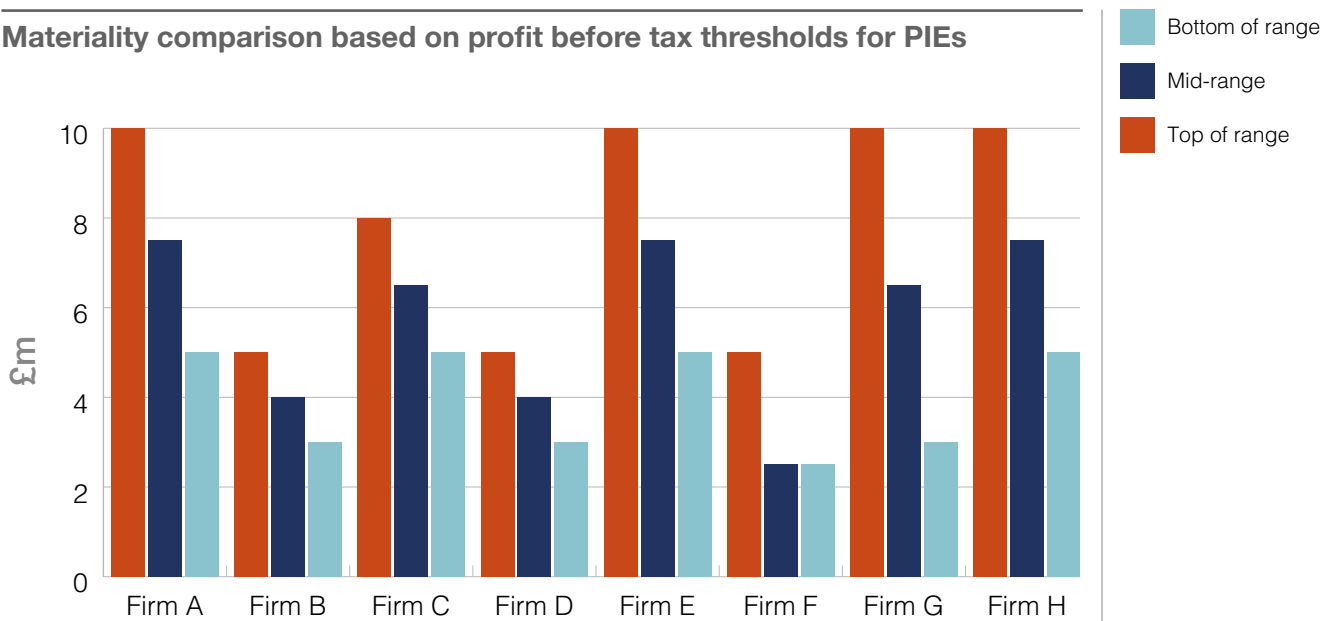
In order to demonstrate the impact of the different ranges of overall materiality percentages used across the firms we have produced an illustrative example of an entity with profit before tax of £100 million and net assets of £500 million.

However, it is also important to note that even if firms align on the same figure for materiality, the nature, timing and extent of the audit work performed will vary depending on other decisions made regarding the audit approach. These decisions include, but are not limited to, the extent of reliance on the testing of operating effectiveness of controls and the methodology underlying the calculation of sample sizes.

<sup>3</sup> As a percentage of overall materiality

<sup>4</sup> 90% is not used for PIEs

## Materiality comparison based on profit before tax thresholds for PIEs



The graph above shows that three of the firms' methodologies result in a considerably lower materiality figure than four of the other firms. In the example, even if the three firms in question set their materiality percentage at the highest end of the range, the materiality calculated would be equivalent to that calculated using the lowest end of the range at four of the remaining five firms.

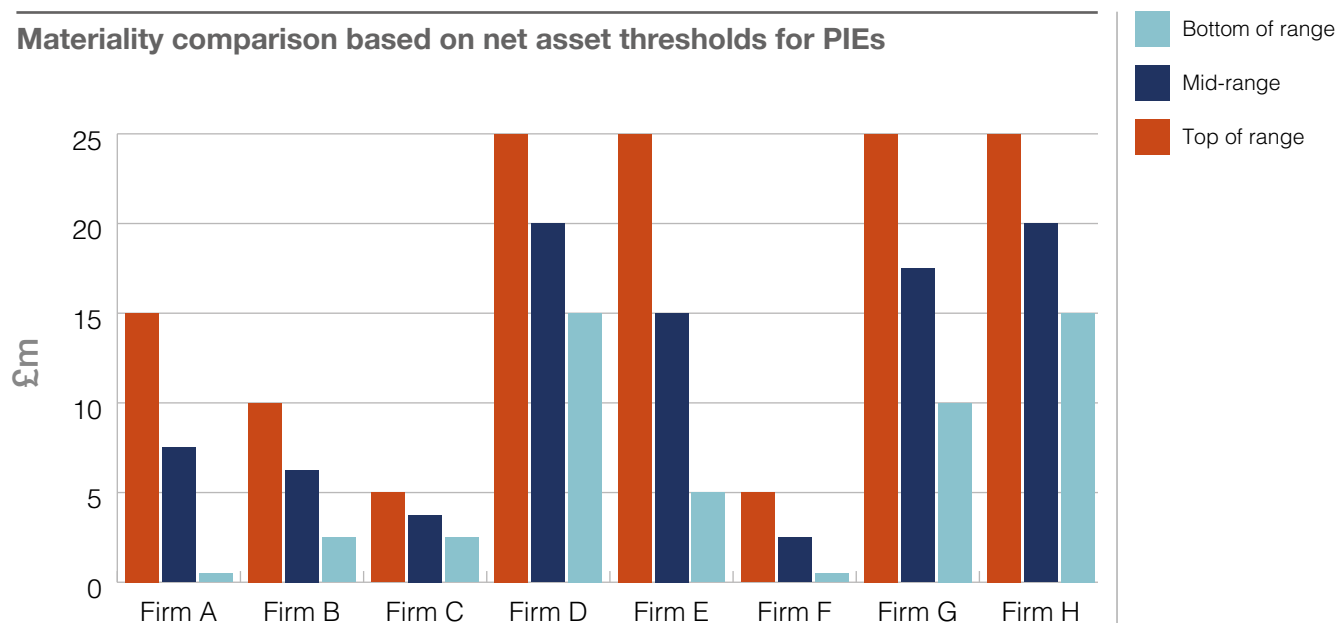
It is therefore possible that the materiality levels set by firms A, E, G and H could be around 100% higher than that of the more prudent firms, B, D, and F. As materiality is fundamental to the planning and performance of the audit, these differences could lead to significantly different audits in terms of the selection of balances for testing; scoping of subsidiary audits; the detailed testing undertaken by the firm and, ultimately, in the conclusions reached by the auditor.

Following our 2013 thematic review, four of the six<sup>5</sup> firms involved in that review introduced lower materiality threshold guidance for profit benchmarks. In contrast, one of the remaining two firms has widened the range within which materiality can be set, thus allowing a higher level of materiality to fall within the firm's guidance, although the upper limit set by this firm is still lower than that of some others.

<sup>5</sup> The 2013 review included BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and PwC LLP only.



## Materiality comparison based on net asset thresholds for PIEs



The graph above illustrates significant differences between the firms in the thresholds used when net assets is the selected benchmark. It is even clearer in relation to this measure than the profit before tax threshold shown before that two firms reach lower materiality levels than the others. In this example materiality could be as low as £1 million and as high as £25 million. As noted above, the materiality calculation will drive the planning, scoping, execution and reporting elements of an audit and higher levels of materiality reduce the audit work undertaken.

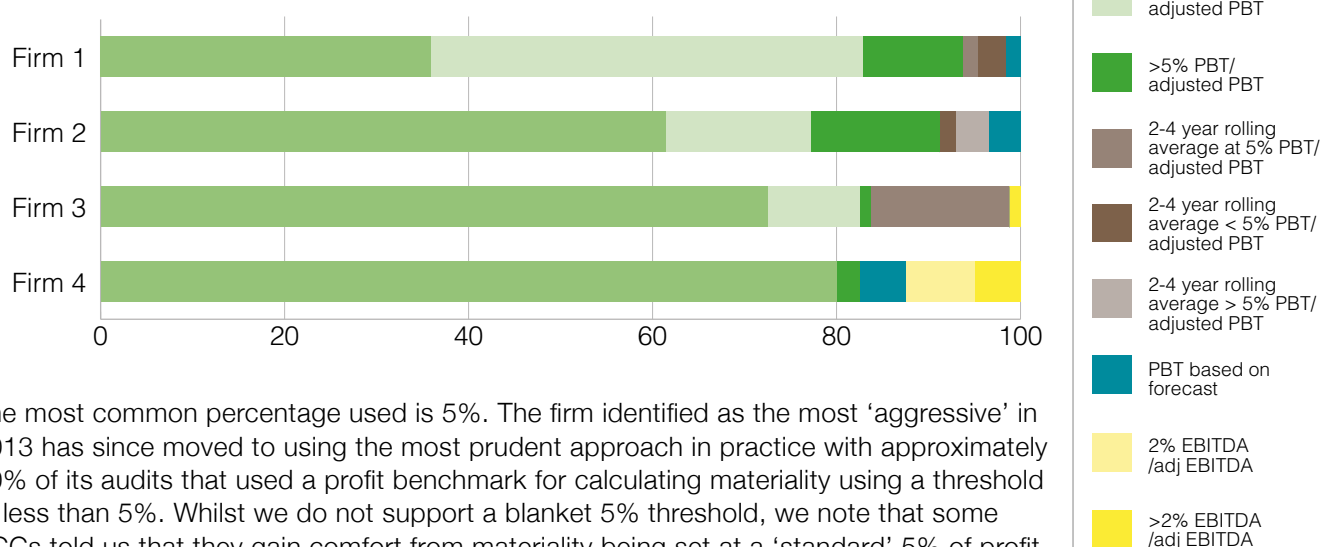
We encourage the firms to continue to reassess their guidance as to the appropriate percentages to apply to benchmarks and consider this in light of changes in the market and the needs of stakeholders. Audit teams should be clear in the judgments made when selecting a percentage to apply to a particular benchmark and be ready to explain that judgment to the Audit Committee.

The analysis in this section illustrates the wide range of materiality levels that may be set by audit teams from different firms, based on their quantitative guidance. Auditors must consider qualitative factors that might be material to the users of the financial statements when making the final determination of materiality.

### 3.4 Application of the firms' quantitative guidance on overall materiality in practice

We have analysed the auditor's reports across the FTSE 350, where a profit measure has been used as the materiality benchmark, to get a picture of how auditors are applying their firm's<sup>6</sup> guidance in practice.

#### Profit based materiality measures disclosed in the most recent audit reports produced by the Big Four across the FTSE 350



The most common percentage used is 5%. The firm identified as the most 'aggressive' in 2013 has since moved to using the most prudent approach in practice with approximately 50% of its audits that used a profit benchmark for calculating materiality using a threshold of less than 5%. Whilst we do not support a blanket 5% threshold, we note that some ACCs told us that they gain comfort from materiality being set at a 'standard' 5% of profit before tax. Accordingly, it is particularly important to explain the judgments taken when a level in excess of 5% is set.

We have also noted that some auditors disclose the percentage of profit before tax of their chosen materiality level, even when the benchmark used for materiality is an adjusted measure. This practice provides a helpful insight for users of the financial statements.

### 3.5 Emerging approaches

In a new development since our last report, some audit teams base materiality benchmarks on a rolling average basis to eliminate volatility and unusual situations in certain markets. This is particularly prevalent for the audit of entities within the extractive industries, where commodity prices can be subject to large short term swings. Three firms permit audit teams to base their materiality calculation on forecast figures.

We have seen instances where the forecast figures used are based on management information and others in which the forecasts are based on external analyst data. In all cases, the audit team must be able to explain why the materiality calculation is appropriate and therefore needs to consider how the forecast position of the entity in future periods is relevant to the assessment of material misstatements in the current year.

This development in audit practice is not explicitly considered within current auditing standards.

<sup>6</sup> Big 4 firms only – Deloitte LLP, Ernst & Young LLP, KPMG LLP and PwC LLP. The other four firms do not have a significant market share in the FTSE 350.

### 3.6 Performance materiality

In order to minimise the risk of the aggregate of uncorrected misstatements being material, auditors set 'performance materiality' thresholds as a basis for planning and performing their audit work. The auditor also uses performance materiality to determine the nature, timing and extent of audit procedures.

Performance materiality is set by reducing overall materiality by an amount often termed a 'haircut'. The degree of reduction depends on the level of risk associated with the audit, with a higher level of risk resulting in a larger haircut and thus lower performance materiality. One of the factors considered by auditors when making the judgment on the 'haircut' is the quality of the internal control environment at the entity. Investors have told us that explaining this in audit reports, would give valuable insight to investors on this aspect of the entity's management and contribute to the value of the audit.

As is set out in the table in section 3.2 the level of performance materiality set by the firms varies. Firms issue supporting guidance regarding what should be considered when assessing the appropriate haircut to the overall materiality levels. ACCs should be aware of the level of performance materiality used by their auditors and be prepared to challenge the audit team on the level set.

Since our 2013 thematic review, there has been an increase in the frequency of audit tendering. In view of this and the potentially heightened risks of not identifying misstatements in a first year audit given the auditor's knowledge of the entity, three firms have issued guidance to their auditors recommending that the level of performance materiality be reduced for a first year audit. We consider this to be good practice.

### 3.7 Clearly trivial threshold

Auditing standards require the auditor to accumulate, consider and report to the Audit Committee misstatements identified during the audit other than those that are clearly trivial. All firms have a consistent range (being between 0-5% of overall materiality) which they consider to be appropriate for determining what is non-trivial. We were pleased to note that some firms require audit teams to consult the firm's technical department when the sum of unadjusted misstatements is near performance materiality considering whether the overall materiality level needs to be reassessed and whether additional audit work should be undertaken.

Currently, a similar consultation is not undertaken when the audit team identifies a high level of adjusted items. Audit firms should ensure that the implications of a higher level of adjusted and unadjusted items is properly considered, including a technical consultation if necessary. A large number of adjusted and unadjusted items in combination provides evidence regarding the quality of the control environment, which may call into question the judgments made regarding the performance materiality 'haircut'. Investors were interested in understanding this.

Audit firms should consider whether a lower performance materiality is appropriate for first year audits, given the increased risks associated with these audits and determine whether guidance in this area should be mandated.

### 3.8 Component materiality

Auditing standards state that component materiality should be set at a level lower than the overall materiality for the group financial statements as a whole, in order to reduce the probability that the aggregate of uncorrected and undetected misstatements across components exceeds overall group materiality.

The firms have various methods for calculating component materiality. As noted in the table in Section 3.2, three firms do not provide quantitative guidance and leave the determination of component materiality to the professional judgment of the audit team. Of the remaining five firms, two provide indicative ranges based on the relative size of the component and three firms use a calculation based on the overall size of the component multiplied by a factor relating to the risk attributed to the component. Providing quantitative guidance on component materiality is good practice and we are pleased to see the firms applying different levels depending on the risks identified at specific components.

For one of the files selected for review, the audit team had set component materiality at the same level as group materiality. This is inappropriate and we have highlighted this point to the firm directly. At the same firm, an issue was identified through their own internal monitoring exercise whereby a component was audited to a higher level than the overall group materiality, again this is inappropriate.

### 3.9 Common themes from our reviews of audit files

As part of this thematic review we reviewed relevant audit working papers for 32 entities in a variety of sectors and the findings have been discussed in detail with the firms. We set out here two common themes relating to the application of the firms methodologies in practice.

- Where performance materiality, component materiality or reporting threshold levels are set at higher than the thresholds recorded in the firm's guidance there is no requirement to consult on this decision with the firm's technical departments.
- There was insufficient justification at three firms where the upper end of the threshold was selected as to the appropriateness of this in relation to the entity under review.

Auditors are required to provide an explanation in their audit opinions of how the auditor applied the concept of materiality in planning and performing the audit. Our review of audit files and the related financial statements concluded that the disclosures around overall materiality are generally helpful and clear. However, where a materiality for a specific account balance is used, this is not always clearly described. Auditors should provide clear information when an account balance-specific materiality is used for certain balances.

Audit firms should include guidance on setting component materiality in their methodologies.

Audit firms should ensure that extended audit reports include a clear explanation of the approach taken when an account balance-specific materiality is used for certain balances.

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### 3.10 Firms' root cause analysis of materiality issues

Seven of the firms included within our review highlighted findings relating to materiality within their internal quality monitoring exercises. The findings related to various aspects of materiality including:

- component materiality being incorrectly calculated or inappropriately applied;
- overall materiality levels being set too high; and
- inappropriate benchmarks being selected.

Firms carried out root cause analysis of these issues at an individual audit level but did not consider whether there could be more systemic or firm-wide factors giving rise to these identified shortcomings. We encourage firms to consider broadening their root cause analysis work on materiality to consider firm-wide causal factors.

### 3.11 Reporting to Audit Committees

Auditors are required to provide the Audit Committee with a written report explaining the findings of their audit, ahead of the financial statements being signed. All firms included within this review provided the necessary document to the Audit Committee. Within this report there is requirement to 'disclose the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level(s) for particular classes of transactions, account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality.'

We were disappointed to note that three Audit Committees had not been made aware of materiality figures either at the planning phase or prior to issuing the audit opinion. We have followed up this matter separately with the two firms involved.

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Audit firms should ensure that Audit Committees of smaller PIEs are aware of the auditor's responsibility to communicate materiality.

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Audit firms should disclose to the Audit Committee the quantitative level of materiality applied to the financial statements as a whole.

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## AUDIT FIRMS SHOULD:

- Consider whether a lower performance materiality is appropriate for first year audits, given the increased risks associated with these audits and determine whether guidance in this area should be mandated.
- Include guidance in their methodologies for audit teams regarding materiality judgments when an entity is loss making.
- Include guidance on setting component materiality in their methodologies.
- Ensure that extended audit reports include a clear explanation of the approach taken when an account balance-specific materiality is used for certain account balances.

## STANDARD SETTERS SHOULD:

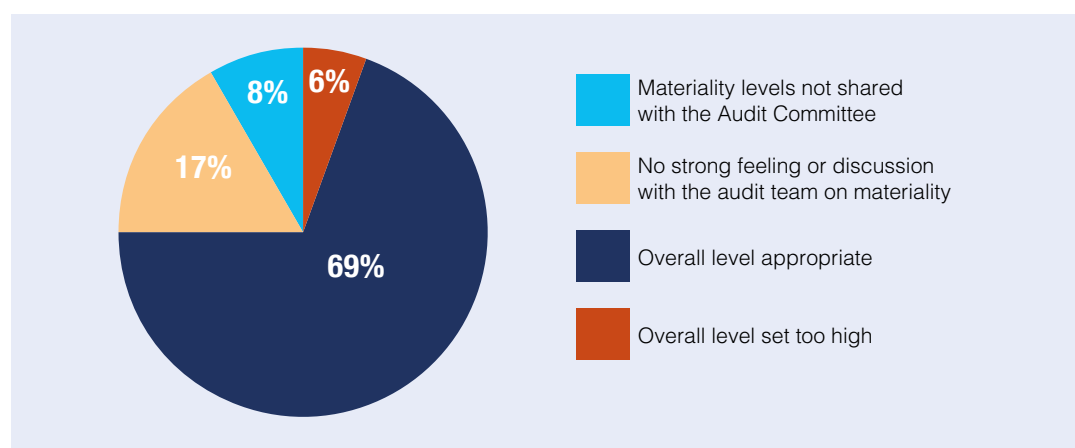
- Consider the appropriateness of using internally and externally generated forecasts in order to calculate materiality and determine whether this satisfies the requirements of the ISA.
- If deemed necessary draft some additional guidance relating to the use of forecast figures within materiality calculations.
- Consider whether the standard should include guidance relating to loss making entities.
- Consider what guidance should be included in updates to the auditing standards related to component materiality.

## 4 Findings from our review – Audit Committees

### 4.1 Views of audit committees

We contacted a number<sup>7</sup> of ACCs to seek their views on various aspects of materiality. The ACCs were from entities operating in a wide range of industry sectors. We focused these discussions on the ACCs' views of the appropriateness of the overall materiality set by the audit team and sought to understand the degree of challenge by Audit Committees of the materiality proposed both, if applicable, within the tendering process and at the planning stage of the audit. Furthermore, we sought their views on the appropriateness of the reporting thresholds set and also discussed component materiality.

#### Audit Committee Chairs views on Materiality levels



17% of the ACCs had neither discussed nor challenged the appropriateness of the level of overall materiality set by the audit team. Given the enhanced requirements for Audit Committees to monitor the effectiveness of the statutory audit this surprised us. Good practice is for committees to discuss the materiality level set and evaluate this in view of their knowledge of the business to determine its appropriateness, challenging the audit team where necessary.

The pie chart shows that of the 36 ACCs we spoke to 6% felt that the overall materiality level set by the audit team was too high. In one of these cases, the Audit Committee's challenge resulted in a reduction in the overall materiality level set for the audit (and an increased audit fee). 69% of ACCs were happy with the level of overall materiality set and did not challenge the auditors on the judgment made. This finding agrees with the results of the FRC's annual survey of ACCs, in which ACCs broadly confirmed they were comfortable with the way in which their auditor had set (and explained) materiality. Four of the 25 ACCs in this category had concluded on the appropriateness of the overall materiality after considering the materiality levels and benchmarks disclosed in the audit

<sup>7</sup> We selected 36 Audit Committee Chairs of PIEs. We selected them as the audit of their entity was included within the inspection programme of the Audit Quality Review team from January 2017- June 2017.

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reports of competitor entities. It is clearly valuable to compare materiality levels and we commend those ACCs who took this initiative. A breakdown of measures used across the various sectors in the FTSE can be seen in Section 2 of this report.

There were no instances where the ACC felt that the overall materiality level set by the audit team was too low. Linked to this point, we identified ACCs interest in the unadjusted errors reported to them by the audit teams. This level of interest was mirrored in the discussions we held with investors (Section 5) who were keen to understand the auditor's view on how management responded to errors identified.

## **4.2 Communication between auditors and audit committees**

We were pleased to note that Audit Committees were using the details of errors in excess of the reporting threshold level to enhance their understanding of the business and challenge management. One ACC explained that the reported unadjusted errors demonstrated clear evidence that the audit team was challenging the entity and gave the Audit Committee confidence in the audit process, as well as an insight into the specific error and the opportunity to understand how and why it arose.

Only 17% of the ACCs had discussed the level of component materiality with the audit team. Of those who reviewed component materiality, one noted that whilst they were aware of the materiality levels at components there was less discussion and challenge in this area and a greater focus on the overall group materiality. One ACC requested that the audit team reduce the materiality for a specific component in view of the Committee's underlying concerns at that component.

As well the key messages to ACCs in our 2013 thematic report (Appendix 1), the FRC has also produced 'Audit Quality - Practice aid for audit committees'<sup>8</sup>, which provides some further guidance for Audit Committees on topics including materiality.

## **4.3 Communication between management and audit committees**

Audit Committees should consider what overall materiality level they would apply to the financial statements and discuss with management what level of materiality is used by management in preparing the financial statements. The Audit Committee and management should consider both qualitative and quantitative factors when considering adjustments to the draft financial statements.

## **4.4 Audit tenders and first year audits**

Of the 36 Audit Committee Chairs contacted, five had recently undergone an audit tender process. Two of the five discussed overall materiality with the audit firms as part of the tender process to obtain an understanding of the proposed level and the impact that this would have on the audit work. In both of these cases, the Audit Committees compared the proposed materiality of the successful auditors with that proposed by others involved in the process.

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<sup>8</sup> <http://www.frc.org.uk/getattachment/1738ea4e-167a-41e5-a701-f169e6b7e264/Audit-quality-practice-aid-for-audit-committees-May-2015.pdf>



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## AUDIT FIRMS SHOULD:

- Ensure that Audit Committees of smaller PIEs are aware of the auditor’s responsibility to communicate materiality.
- Disclose to the Audit Committee the quantitative level of materiality applied to the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions, account balances or disclosures and the qualitative factors which were considered when setting the level of materiality.

## AUDIT COMMITTEES SHOULD:

- During the tender process, consider the appropriateness of the proposed benchmark and overall materiality level and question how this impacts upon the proposed work to be performed.
- Discuss with management the level of materiality used when preparing the financial statements.
- Discuss materiality with the audit team:
  - as part of the audit planning process – challenging the level and benchmarks used;
  - seek clarity on how the performance materiality used affected the work undertaken, particularly in relation to areas of significant risk;
  - assess its appropriateness and whether any reassessment was required at the year end; and
  - when assessing the appropriateness of the materiality benchmark used, consider whether it would be valuable and appropriate to have a separate materiality level for a specific financial statement line item.
- Audit Committees should obtain an understanding from the team of those balances considered immaterial and therefore not tested.
- Consider the appropriateness of the component materiality set, particularly where issues or changes have arisen in a specific component.
- Assess whether the information included within the audit committee report could be improved to:
  - provide additional clarity and insight on the judgments made in preparing the financial statements; and
  - provide users of the financial statements with evidence of the degree of challenge by the audit team in the areas of risk which had the most significant effect on the audit strategy.

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## 5 Findings from our review – Investors

### 5.1 Understanding of materiality

The FRC hosted a roundtable on materiality for investors in September 2017. The roundtable was designed to gain an insight into investors' views on audit materiality and their level of understanding of the impact of materiality on an audit. We also sought feedback on how investors use the information on materiality included within the extended audit report.

The majority of investors involved in the roundtable said that there was a lack of understanding of the concept of audit materiality, with a common misconception being that there is a standard method across all audit firms of calculation. One investor noted that 'If you ask most investors they would not even have any appreciation that there is a range of numbers'.

We highlighted examples of various benchmarks used by the audit firms in relation to overall materiality and discussed the merits of each of these and whether any were considered to be more useful than others. Investors focused on the key drivers of the business; in line with the firms' methodologies which encourage audit teams to identify the benchmark most appropriate to the entity in view of various factors such as the industry, the economic environment within which it operates, the focus of users and the business's key performance indicators.

### 5.2 Adjusted profits

Profit measures continue to be the most commonly-used benchmark for overall materiality calculations within the FTSE 350. One investor noted that investors and analysts focus on pre-exceptional figures, adding back adjustments for 'exceptional' items where the same items are adjusted for year after year.

In our 2013 thematic review on materiality, we raised concerns regarding the exclusion of recurring items such as amortisation and impairment when calculating normalised profit figures. Auditing standards note that adjustments to profit should be exceptional when considering whether they should be included in the benchmark for calculating overall materiality. We continue to see recurring adjustments to underlying profit figures being made by all firms with no clear evidence of justification as to the appropriateness of these adjustments.

Audit firms should reiterate to their teams the importance of ensuring that the profit benchmark used reflects the needs of the users of the financial statements and that adjustments to profit are for truly exceptional items, such as one-off restructuring costs, rather than impairments for items that are different each year, but which are, in reality, a regular part of the cost base of the business. Furthermore, audit firms should consider including with their audit report details of how the adjusted profit figure, upon which the overall materiality calculation was based, was determined and why the adjustments were considered to be necessary. The profit-related benchmark used to calculate materiality should be clearly disclosed.

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Audit firms should actively engage with investors to reduce the confusion relating to audit materiality and provide clear explanations as to how materiality, including any account balance-specific materiality, is determined and used during the audit.

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Audit firms should reiterate the importance of ensuring that adjustments to profit are purely for exceptional items and responsive to the needs of users of the financial statements. Furthermore, audit firms should consider including details of how the adjusted profit figure upon which the materiality calculation was based was determined and why the adjustments were considered to be necessary.

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### 5.3 Extended auditor reports

Extended audit reports are designed to improve transparency for users of the financial statements. Disclosure of the overall materiality calculation and its application is a key element to support enhanced understanding of the audit process.

Investors welcomed the increased transparency on materiality provided by the extended audit report. They noted their focus on the percentage applied, rather than having a view on an absolute number as being material for the entity. Materiality of up to 5% of PBT was their typical expectation. In view of these comments we recommend that the firms justify the use of greater than 5% on profit-based benchmarks. For four of the firms reviewed, this was at the lowest end of their threshold guidance.

Investors considered that the explanations in extended audit reports regarding the determination and use of an account balance-specific materiality for the audit of certain items within the financial statements were not clear.

### 5.4 Unadjusted errors

Investors wanted to obtain an understanding of the level of challenge provided by auditors during the audit process. All investors attending the roundtable wanted more colour on the types of unadjusted and adjusted errors (at both full scope and limited scope components) identified by auditors. This would provide insight into how prudent or aggressive the entity was on key areas of judgment. 'Disclosure of the adjustments made would be very helpful'.

Another investor commented that 'if the business is reporting divisional results, [I would] expect to see divisional materiality disclosed'. The disclosure of component or divisional materiality would be within the guidance on audit reporting.

Audit Committees of companies applying the Corporate Governance Code should consider what additional information would be useful to investors when drafting their reports in the annual report.

### 5.5 Performance materiality

There was very limited understanding of the concept of performance materiality among investors, however, investors were interested in any insight the auditor could provide into the attitude of management to risk and profit recognition, as well as the quality of the control environment at the entity. The difference between overall materiality and performance materiality, if well explained in the audit report, can give valuable insight into the auditors' views on the internal controls of the entity.

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Audit firms should ensure that extended audit reports include clear explanations of both the use of account balance-specific materiality measures and the application of materiality to areas of estimation or judgment such as goodwill, loan loss provisioning and assets that are more difficult to value.

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## 5.6 Component materiality

The discussion on component materiality focused on a theoretical position where the sum of unadjusted errors within components could be greater than overall group materiality and how an auditor and Audit Committee might deal with this situation. Attendees were surprised that each firms' guidance enabled the sum of materialities at the various components (subsidiary or division) to exceed overall group materiality. While this is not, in principle, inconsistent with the Auditing Standards, we encourage the audit firms to work with investors to explain this concept.

### AUDIT FIRMS SHOULD:

- Actively engage with investors regularly to reduce the confusion relating to audit materiality (overall, performance and component) and provide clear explanations as to how materiality, including any account balance-specific materiality, is determined and used during the audit.
- Ensure that extended audit reports include clear explanations of both the use of account balance-specific materiality measures and the application of materiality to areas of estimation or judgment such as goodwill, loan loss provisions and assets that are more difficult to value.
- Reiterate the importance of ensuring that adjustments to profit are purely for exceptional items. Furthermore, audit firms should consider including details of how the adjusted profit figure upon which the materiality calculation was based was determined and why the adjustments were considered to be necessary.

### INVESTORS SHOULD:

- Develop their understanding of the audit process and the support it provides to the functioning of the capital markets. This includes gaining a better understanding of audit materiality (overall, performance and component levels) and being comfortable with challenging company directors on the approach taken by their auditors.

## Glossary

<b>Benchmark</b>	A balance in the financial statements identified by the auditor as being of key interest to users of the financial statements and used as the basis for setting materiality.
<b>Clearly trivial/ reporting threshold</b>	An amount designated by the auditor below which identified misstatements are not reported by the auditor to those charged with governance. This is usually set by the auditor and reported to those charged with governance as being a small percentage of materiality.
<b>Component</b>	An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.
<b>Component materiality</b>	The materiality for a component determined by the group engagement team.
<b>Difference/ misstatements (these can either be adjusted or unadjusted)</b>	A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.
<b>Group materiality</b>	The materiality set by the group auditor in respect of group financial statements.
<b>Overall materiality</b>	The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. In general, 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. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.
<b>Performance materiality</b>	The amount or amounts set by the auditor at less than overall 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. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

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## Appendix 1 – Key messages for Audit Committees

- During the tender process, consider the appropriateness of the proposed benchmark and overall materiality level and question how this impacts upon the proposed work to be performed.
- Discuss with management the level of materiality used when preparing the financial statements.
- Understand and challenge the basis for the materiality levels set and the benchmark used including, in particular, how these reflect the needs and expectations of users of the entity's financial statements.
- Understand how materiality levels are expected to affect the level of audit work performed, particularly in relation to areas of significant risk.
- Consider whether it would be valuable and appropriate to have a separate materiality level for a specific financial statement line item.
- Understand the reasons for, and the effect of, any increases in materiality levels, including whether their auditors believe that the needs and expectations of users of the entity's financial statements have changed and the likely impact on the level of audit work undertaken.
- Understand those balances considered immaterial and therefore not tested.
- Understand how auditors are ensuring that materiality is being determined appropriately at group and component levels, particularly where issues or changes have arisen in a specific component.
- Where actual results are worse than forecast or significant events arise near the year-end, Audit Committees should discuss with their auditors whether the materiality levels set need to be revised and the nature and extent of the audit work performed remains appropriate.
- Understand why management have not adjusted the financial statements for uncorrected misstatements brought to their attention by the auditors and instruct management to make the relevant adjustments where appropriate.
- Understand whether disclosure omissions reported to them by the auditors have arisen through error or a specific management judgment and assess whether the inclusion of the disclosures concerned is likely to provide material information to users of the financial statements.
- Obtain confirmation from their auditors that any changes subsequently made to the materiality levels and reporting threshold initially advised have been reported to them.

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- Assess whether the information included within the audit committee report could be improved to:
    - provide additional clarity and insight on the judgments made in preparing the financial statements; and
    - provide users of the accounts with evidence of the degree of challenge by the audit team in the areas of risk.

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