STAFF GUIDANCE NOTE 03/2017

The auditor's consideration of materiality relating to other information

In accordance with ISA (UK) 720 (Revised June 2016)[1] and relevant applicable law[2], where the auditor either identifies that a material inconsistency exists, or becomes aware that the other information may be materially misstated, the auditor needs to conclude whether there is a material misstatement of the other information. In order to do so, the auditor needs to determine what would constitute a material misstatement. This is an area requiring careful professional judgment, and the auditor needs to document their thinking and rationale for the audit file.

What is the concept of materiality under the ISAs?

The concept of materiality for the audit is discussed in ISA (UK) 320 and is discussed further, in the context of how it applies to other information, in ISA (UK) 720 (Revised). Where the applicable financial reporting framework, or a framework applicable to the other information, discuss the concept of materiality, such a framework may provide a basis to support the auditor in making judgments about materiality respectively under the ISAs[3] and under ISA (UK) 720 (Revised)[4]. Auditors may also find it helpful to discuss this with those charged with governance.

Where such a discussion is not included in such a framework, the basis used by the auditor in making judgments about materiality under the ISAs and under ISA (UK) 720 (Revised) is respectively set out in paragraph 2 of ISA (UK) 320 and paragraph A7 of ISA (UK) 720 (Revised). Such a frame of reference includes, in the context of the other information, consideration of:

- Common information needs of users of the other information (who are expected to be the same as the users of the financial statements)
- Whether users' economic decisions would be affected in the specific circumstances
- The nature or magnitude of the items addressed.

How does the auditor make judgments about materiality for other information?

Application of the concept of materiality for the audit is not necessarily the same for the financial statements and the other information in the annual report. This may be because the

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1 ISA (UK) 720 (Revised June 2016) The Auditor's Responsibilities Relating to Other Information.

2 The auditor needs to consider the legislation and regulation that governs the content and form of the other information where applicable.

3 ISA (UK) 320 para 3

4 ISA (UK) 720 (Revised), para A7

financial reporting framework discusses the application of materiality in a different way to how it is discussed in the framework applicable to the other information.

For other information, the auditor considers whether it is subject to a framework which provides a frame of reference for the auditor’s judgments about materiality under ISA (UK) 720.[5]

In the UK, legislation sets out what other information is required in an annual report (excluding the financial statements and the auditor's report thereon). For example:

- A directors' report.
- A strategic report.
- A non-financial information statement (NFIS), included in the Strategic Report.[6]
- A separate Corporate Governance Statement.
- A trustees' report.

The relevant legal requirements do not refer to or define "materiality". They do, however, include terms which are intended to ensure that all relevant information and only that information is provided. For example, the strategic report requirements uses terms such as "principal" (e.g. principal risks), "key" (e.g. key performance indicators) and "necessary for an understanding of" (e.g. the strategic report must contain information to the "extent necessary for an understanding of the company's development, performance and position and the impact of its activity…").[7] These and similar principles, when considered in the context of an entity can be considered as relevant discussion of what other information would be material for inclusion in the annual report. However, to the extent that the relevant legal requirements do not provide a comprehensive discussion of the application of the concept of materiality to such other information, the frame of reference provided by ISA (UK) 720 (Revised) is also relevant to the auditor’s judgments about materiality.

In addition, other information in the Strategic Report is material if its omission or misrepresentation could reasonably be expected to influence the economic decisions shareholders take on the basis of the annual report as a whole.[8]

Material misstatements of the other information

ISA (UK) 720 (Revised June 2016) states that "a misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information). A misstatement of the other information also exists when the statutory

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5 ISA (UK) 720 (Revised June 2016), paragraph A7.

6 For financial years beginning on or after 1 January 2017, certain entities are required to include a NFIS in their strategic report. As the NFIS is part of the strategic report it meets the definition of both Other Information and Statutory Other Information as defined in ISA (UK) 720 (Revised June 2016).

7 Paragraph 5.1 of *[Draft] Guidance on the Strategic Report, Section 5 The strategic report: materiality* published by the FRC in August 2017.

8 Paragraph 5.2 of *[Draft] Guidance on the Strategic Report, Section 5 The strategic report: materiality*.

other information has not been prepared in accordance with the legal and regulatory requirements applicable to the other information."[9] The auditor therefore assesses whether any misstatement of the other information is material, taking into account both the size (quantitative factors) and the nature (qualitative factors) of the misstatement.

Examples

Example 1

The Strategic Report discloses that the ongoing success of the company is attributable to organic growth. However, there has been at least one material acquisition each year for the past three years.

A user of the annual report may view the company's longer term prospects differently depending on whether growth is organic or by acquisition, and therefore the auditor may determine that the failure of the directors to highlight how the acquisitions have contributed to the growth of the company is a material misstatement of the other information.

Example 2

Company law requires the company to disclose political donations if the aggregate donations are in excess of a given amount. The auditor may initially determine that a donation which is above the threshold for which company law requires disclosure, but is below the auditor's overall materiality for the audit is not quantitatively material; however, the auditor also considers qualitative factors in the assessment of materiality. The auditor's determination of whether a misstatement in the amount of political donations is material or not may vary in the specific circumstances of the entity as follows:

- The entity has not disclosed a donation of £2,100 – As the Companies Act threshold for disclosure is £2,000 and no disclosure is made in the annual report, the auditor is likely to conclude that this is a material misstatement.
- The entity has disclosed donations of £2,100, but the auditor has identified donations of £2,500 – Subject to understanding why the error has happened, the auditor may conclude that this is not a material misstatement as some donations have been disclosed, but a users' economic decision is unlikely to be affected if the disclosure is amended in the financial statements.
- The entity discloses donations of £20,100, but the auditor has identified donations of £50,000 – Even if this misstatement falls below the auditor's assessed clearly trivial threshold when considered by order of magnitude,[10] the nature of the misstatement means the auditor is likely to conclude that this is a material misstatement.

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9 ISA (UK) 720 (Revised June 2016), paragraph 12(b).

10 ISA (UK) 320 (Revised June 2016), paragraph A2.