Financial Reporting Council

December 2013

Audit Quality Thematic Review

Materiality

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1 Background, scope and key messages

1.1 Background and scope

This report sets out the principal findings of the first of two thematic inspection reviews undertaken by the Financial Reporting Council's ("FRC") Audit Quality Review ("AQR") team during 2013. The theme for this review was the auditor's consideration and application of materiality. We will report on the findings of our second thematic review for 2013, covering the auditor's identification of and response to fraud risks and relevant laws and regulations, in January 2014.

From 2013 thematic reviews will supplement our annual programme of audit inspections[1] of individual firms. In a thematic review we look at firms' policies and procedures in respect of a specific aspect of auditing, and their application in practice. The reviews are narrow in scope, and the specific aspect may be chosen in order to focus on it in greater depth than is generally possible in our inspections or because our inspection findings have suggested that there is scope for improvement in the area concerned. A thematic review enables us to look at an aspect of auditing in more depth, and to make comparisons between firms with a view to identifying both good practice and areas of common weakness.

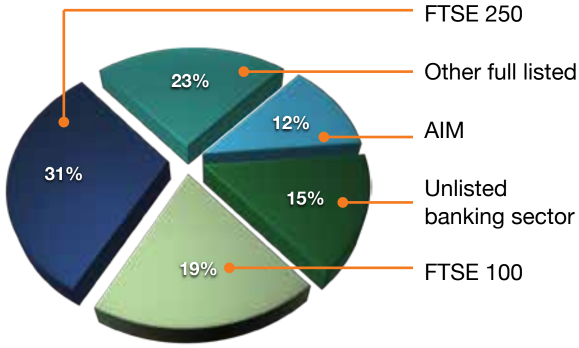
The theme for this review was chosen because it is an area of particular interest to investors given its potential impact on the scope of an audit and the extent of the audit work performed. This is reflected in the recent revision of ISA (UK and Ireland) 700 (ISA (UK&I) 700) that requires auditors to report how they applied the concept of materiality in performing the audit and how this affected the scope of their audit. A key objective was to promote an enhanced understanding by auditors, Audit Committees and investors of the judgments that need to be exercised in determining materiality levels and in applying them during the audit.

This report should promote a better understanding of current practice at the largest firms and how materiality decisions affect the scope and extent of auditors' work. Our findings and recommendations should assist auditors in reviewing current guidance and practice at their firms with a view to better fulfilling their professional responsibilities. They should also assist Audit Committees in discharging their oversight responsibilities.

We visited the six largest audit firms (BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit plc and PricewaterhouseCoopers LLP) to review their audit methodology and guidance in respect of materiality. We also reviewed relevant aspects of the audit procedures performed for 26 entities in the retail, construction, real estate, industrial products, support services, banking, software and mining industries. These reviews related to audits of financial statements for financial year ends between March 2012 and March 2013. At least one entity which was near break-even or was loss-making was selected at each firm in order to assess how auditors used their judgment in determining materiality.

The observations made in this report are based on our review of firms' procedures and guidance and relevant parts of the audits we selected, including how materiality was used to plan and perform audit work relating to specific account balances, classes of transactions or disclosures. We have discussed our findings with each of the audit firms concerned.

A summary of the companies covered by the audits we reviewed is set out below:



1.2 Overview and key messages

This section provides an overview of areas of good practice identified at one or more firms; our principal findings set out in section 2; and identifies a number of key messages, of relevance to both audit firms and Audit Committees, arising from the findings of our review.

1 Audit Quality Inspections Annual Report 2012/13: Section 4 – Summary of activities

Good practice observations

- Monitoring the materiality level set on all audits for a specified period and, where materiality was being set at a level outside the firm's suggested ranges, reviewing whether there was reasonable justification for this.
- Using an exceptions report to identify where no justification for the materiality benchmark or percentage used has been recorded.
- Providing specific guidance for industry sectors where the judgments involved may be more complex, for example pension funds, mutual funds, insurance companies, banks and building societies, mining companies and real estate/property companies.

Overview of findings

- Five of the six firms have recently made changes to their materiality guidance which may either lead to higher materiality levels being set or the impact of materiality assessments on the level of audit work performed being reduced.
- Some firms have significantly higher permitted acceptable percentage ranges than others for determining both overall materiality and performance materiality, particularly those firms that do not distinguish for this purpose between public interest and non-public interest entities. This may result in less audit work being performed, in relation to entities of similar size and risk profiles, than at other firms. It may also lead to more variability in materiality judgments within firms.
- All firms have templates for setting overall materiality, performance materiality and 'clearly trivial' limits; for revising materiality during the audit; and for evaluating unadjusted errors. While the templates require or encourage narrative explanations of judgments made, auditors did not always appropriately explain and justify their judgments in completing these.
- In the majority of cases materiality levels set were the maximum permitted under the firm's guidance, irrespective of the risks identified. Such an approach is not consistent with appropriate exercise of individual judgment as required by Auditing Standards.
- Auditors did not always appropriately consider revising materiality levels that had been based on forecast results when actual performance was significantly worse than forecast.
- We saw many examples of accurate and high quality reporting to Audit Committees. However, in four audits the audit teams recorded and collated errors at a higher level than the reporting threshold advised to the Audit Committee; in six audits, the audit teams did not report all errors above the reporting threshold; and in one audit there was no reporting of materiality levels or considerations to the Audit Committee.

Key messages for audit firms

- The qualitative guidance provided to assist audit teams in making materiality judgments has been improved at a number of firms in recent years. However, firms should review their guidance to ensure that it appropriately addresses areas requiring improvement identified in this report. These include:
    - promoting the use of judgment in determining materiality levels, including performance materiality;
    - considering whether to distinguish between public interest and non-public interest entities in the setting of materiality levels (some firms do this whereas others do not);
    - improving the quality of guidance to assist audit teams' consideration of component materiality on group audits;
    - requiring internal consultation where either complex judgments are required or audit teams propose to use a higher percentage of a chosen benchmark than is generally used within the firm for determining materiality; and
    - providing additional industry-specific guidance or enhancing existing industry-specific guidance.

- Auditors should ensure that where benchmarks used are adjusted for 'one-off' items, these adjustments are appropriate in the circumstances. Firms should ensure that their guidance assists audit teams in making these judgments.

- Auditors should demonstrate the consideration of risk in setting performance materiality and avoid, as a default, simply setting this at the highest level allowed under their firm's guidance.

- Auditors should improve the quality and accuracy of their reporting of materiality levels to Audit Committees and ensure that all uncorrected misstatements above the reporting threshold agreed are collated and reported.

- Auditors should ensure that materiality is appropriately addressed when planning analytical procedures.

Key messages for Audit Committees

Audit Committees play an essential role in ensuring the quality of financial reporting. In particular, their work in discussing with auditors the audit plan and the audit findings can contribute greatly to audit quality. To assist Audit Committees, we have summarised below the matters which we believe may enhance their oversight of the audit process in relation to materiality and thereby contribute to an overall improvement in audit quality. In some instances these matters are similar to those of relevance to auditors, while in other cases the emphasis differs.

- Audit Committees have an important role to play in ensuring that the materiality levels set are appropriate. They should seek to understand the basis for the materiality levels set including, in particular, how these reflect the needs and expectations of users of the entity's financial statements.

- Audit Committees should seek to understand how materiality levels are expected to affect the level of audit work performed.

- Audit Committees should seek to understand the benchmarks used by their auditors in determining materiality levels and why these are considered to be appropriate.

- Audit Committees should seek to 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.

- Audit Committees should seek to gain an understanding of how materiality levels affect the extent of audit work undertaken in significant areas.

- Audit Committees should seek to understand how auditors are ensuring that materiality is being determined appropriately at group and component levels.

- 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.

- Audit Committees should ensure they 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.

- Audit Committees should seek to 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.

- Audit Committees should seek confirmation from their auditors that any changes subsequently made to the materiality levels and reporting threshold initially advised have been reported to them.

1.3 Consideration of materiality in auditing

It is recognised in Auditing Standards that the setting of materiality is a key part of the audit. ISA (UK&I) 320 'Materiality in planning and performing an audit' explains 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. Information is material if misstating or omitting it could influence decisions that users make on the basis of an entity's audited financial statements. Misstatements or omissions may be judged to be material by virtue of either their size or nature or a combination of both of these.

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, which 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.

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 and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to the potential for 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 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 key factors in determining the level of audit work 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.

New reporting requirements for auditors under ISA (UK&I) 700 (revised), effective for accounting periods commencing on or after 1 October 2012, require auditors to report how they applied the concept of materiality in planning and performing the audit. These new requirements will provide increased visibility of the impact of materiality on the conduct of audit work to investors and other users of the accounts and enable them to engage directly with Audit Committees in relation to this area.

The FRC will monitor how auditors are applying the new reporting requirements in practice during 2014 and consider the implications for other initiatives designed to enhance the quality and value of auditing and the effectiveness of auditors' communications with stakeholders.

2 Principal findings

The auditor's responsibilities relating to applying materiality in planning and performing an audit, and in evaluating the effect of identified misstatements on the financial statements, are set out in ISAs (UK&I) 320 and 450. In meeting these responsibilities audit firms should pay particular attention to our principal findings set out below.

The principal findings we highlight in this report relate to:

- Overall materiality
- Recent changes to firms' guidance and processes for setting overall materiality
- Performance materiality
- Setting materiality for account balances, classes of transactions and disclosures
- Impact of materiality on audit work
- Impact of materiality on group audits
- Revisions to materiality
- Impact of materiality on unadjusted misstatements
- Communications with the audit committee
- "Clearly trivial" misstatements

2.1 Overall materiality

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.

(ISA (UK&I) 320 para 4)

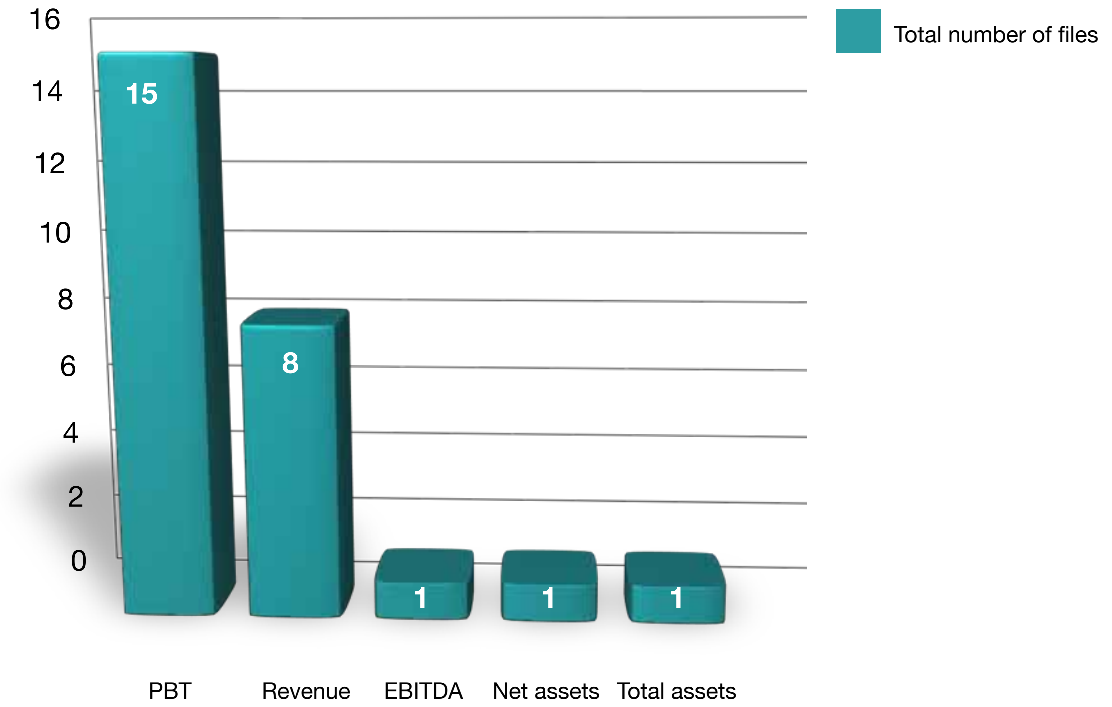
Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

(ISA (UK&I) 320 para A3)

Determining the benchmarks to be used

Some firms provided detailed guidance as to which benchmark (for example, profit before tax or net assets) should be used in certain circumstances, whilst other firms had less prescriptive guidance for selecting benchmarks to allow judgment to be exercised by audit partners. Firms' guidance to audit teams should balance the need to support audit partners and staff in selecting an appropriate benchmark with encouragement for them to exercise judgment in the light of the specific circumstances of the audited entity. A number of benchmarks were used on the audits reviewed; profit before tax was used in 15 audits and revenue was used in 8 of the remaining 11 audits:



ISA (UK&I) 320 suggests that one of the factors that auditors should consider when determining the benchmark to be used is whether there are items on which the attention of users of the entity's financial statements tends to be focused for performance evaluation purposes. In over a third of the audits we reviewed, the benchmark used by the audit team was not identified by the directors as a financial key performance indicator in the Annual Report. Whilst there may be good reasons for this, the reasons were not explained on any of the audit files we reviewed. While profit before tax is expected to be the main financial benchmark for most listed trading companies, auditors should seek to understand the key financial performance indicators identified by an entity's directors and why the use of an alternative benchmark for determining materiality may be appropriate in a particular case.

ISA (UK&I) 320 states that in relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations figure based on past results.

(ISA (UK&I) 320, paragraph A5)

We noted instances where auditors adjusted the benchmark used, typically profit before tax, to achieve a normalised figure as allowed by Auditing Standards. However, in some audits the amounts adjusted related to amortisation of intangible assets such as brands or goodwill that recur each year and, in one audit, the losses incurred by a subsidiary were added back. These did not appear to be exceptional one-off items for which adjustment should be made to achieve a normalised profit figure. Firms' guidance should only permit the making of adjustments to the chosen benchmark where these can be fully justified by the audit team. We have raised this matter with the firms concerned.

Guidance for determining the percentage to be applied against the benchmarks

All firms had comprehensive qualitative guidance regarding consideration of users' expectations, volatility and other factors that affect materiality and provided practical examples to assist audit teams. However, there often appeared to be a disconnect between the need to exercise judgment in setting materiality levels, as set out in Auditing Standards, and aspects of firms' guidance that reflected a more mechanical approach. The range of guidance we reviewed included the following:

- Guidance that presumed that a specific benchmark and percentage thereof would be applied for all listed profit-orientated entities.

- Guidance that encouraged auditors to exercise judgment in determining materiality and then check that this was within a specified reasonable range (rather than following a more formulaic approach).

- Guidance that left the determination of the percentage to be applied for certain benchmarks entirely to the engagement partner's judgment (which creates a risk that outliers may arise).

A summary of firms' quantitative guidance is set out in the table below:

Benchmark	Firm 1	Firm 2	Firm 3	Firm 4	Firm 5	Firm 6
Profit before tax – Listed/PIE	up to 5%	5%	3% to 10%	3% to 10%	5% to 8%**	5 to 10%
Profit before tax – non-Listed/non-PIE	5% to 10%	5% to 10%	3% to 10%	3% to 10%	5% to10%	up to 10%
Gross profit – Listed/PIE	up to 2.5%	-	-	3% to 10%	1% to 2%	partner judgment
Gross profit – non-Listed/non-PIE	up to 3.5%	-	-	3% to 10%	1% to 4%	partner judgment
Net assets – Listed/PIE	0.5% to 1%*	0.5% to 1%*	2% to 5%	3% to 10%	1% to 2%	up to 3%
Net assets – non-Listed/non-PIE	1.75 to 2%*	0.5% to 1%*	2% to 5%	3% to 10%	1% to 5%*	up to 3%
Revenue – Listed/PIE	up to 1%	0.5% to 2%	0.5% to 2%*	0.5% to 3%	0.5% to 1%	0.8% to 5% on sliding scale
Revenue – non-Listed/non-PIE	up to 2%	0.5% to 2%	0.5% to 2%*	0.5% to 3%	0.5% to 2%	0.8% to 5% on sliding scale
Total assets – Listed/PIE	up to 0.5%	0.5% to 2%	1% to 2%	0.5% to 3%	0.5% to 1%	-
Total assets – non-Listed/non-PIE	up to 2%	0.5% to 2%	1% to 2%	0.5% to 3%	0.5% to 2%	-

*Maximum percentage depended on whether entity was a Mutual or Pension Fund.

**Consultation required above 5%

As shown above, three firms specify a lower percentage range for listed/public interest entities whereas the other three firms draw no such distinction.

Two firms had guidance stating that materiality percentages would often increase as the size of the audited entity decreases. An inverse relationship between the size of an entity and the materiality percentages applied would not usually be expected, although it is possible that materiality may need to be reduced for a very large entity to meet users' expectations.

Impact of judgment on overall materiality

The selection of a benchmark, and a percentage thereof within the range set out in a firm's guidance, is likely to have a significant impact on the overall materiality level determined which may, in turn, affect the level of audit work performed. This is illustrated in the examples on the next page:

Example A

A FTSE 250 public interest entity in the retail sector generates revenue of £5bn, a gross profit of £2bn and a profit before tax of £0.5bn.

If the guideline percentages for the revenue, gross profit and profit before tax benchmarks were used by the audit team, overall materiality would be as follows:

Benchmark	Firm 1	Firm 4	Firm 6
Revenue	up to £50m	£25m to £125m	circa £40m
Gross profit	up to £50m	£60m to £200m	partner judgment
Profit before tax	up to £25m	£15m to £50m	£25m to £50m
Possible range	**Up to £25m to up to £50m**	**£15m to £200m**	**Partner judgment or £25m to £50m**

Example B

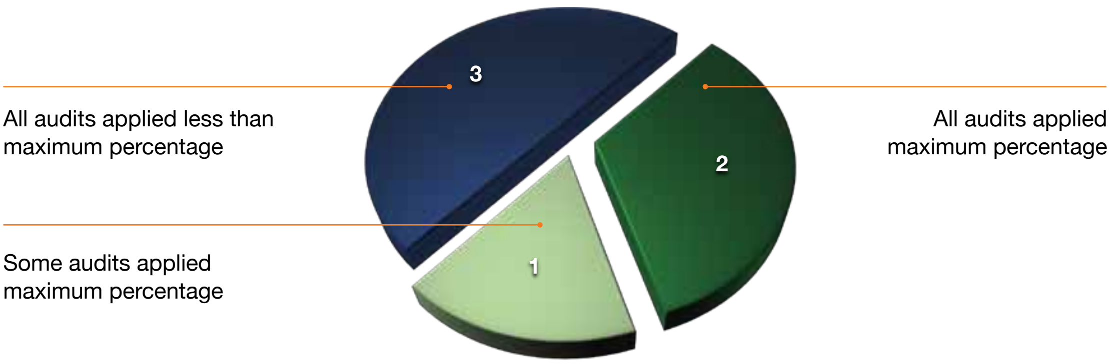
A FTSE 250 public interest entity in the real estate sector has total assets of £1bn and net assets of £0.6bn.

If the guideline percentages for the net assets and total assets benchmarks were used by the audit team, overall materiality would be as follows:

Benchmark	Firm 1	Firm 4	Firm 6
Net assets	£3m to £6m	£18m to £60m	up to £18m
Total assets	up to £5m	£5m to £ 30m	-
Possible range	**£3m to £6m**	**£5m to £60m**	**up to £18m**

Determining the percentage to be applied against the benchmarks

A summary of the extent to which the maximum percentage of the relevant benchmark allowed by each firm's guidance was used on the audits reviewed is set out below:



As shown above, at two firms there appeared to be a tendency to default to, or justify the use of, the highest materiality level allowed by the firm's guidance, which does not appear consistent with the exercise of appropriate judgment.

However, the firms at which audit teams appeared to exercise greater judgment (in that they did not default to maximum) tended to permit the use of broader percentage ranges in their guidance. Although it seemed that teams were reluctant to use the top of the ranges in practice, this nevertheless generally resulted in higher materiality levels being set compared with those firms at which audit teams defaulted to the maximum percentage permitted.

For example, at one firm where the highest permissible percentage was not used on any of the audits reviewed (appearing to demonstrate the exercise of judgment), the actual percentage used in determining materiality was higher in most audits than the permissible range at those firms where all audit teams defaulted to the maximum percentage allowed.

While positive factors were identified to justify a higher materiality level on a number of audits reviewed, factors suggesting a lower materiality level may have been appropriate were not always given appropriate consideration. For example:

- On one audit we identified materiality being set above the firm's maximum guidelines after consultation with the firm's technical team. However, there was no evidence of consideration that the audited entity was in the firm's highest risk category due to going concern issues and historically high levels of errors identified by the audit team.

- The audit on which the highest percentage of the profit before tax benchmark was used in determining materiality was a first year audit for the firm concerned.

However, we did find evidence of some good practice in this area, with firms' processes ensuring that auditors completed a narrative explanation justifying the materiality levels set (and benchmarks used) and any non-completion being identified in exception reports to be followed-up.

Audit Committees should seek to understand the basis for the materiality levels set, including how they reflect the needs and expectations of users of the entity's financial statements, and the likely impact on the level of audit work performed. They should also seek to understand the benchmarks used by their auditors in determining materiality levels and why these are considered to be appropriate.

2.2 Recent changes to firms' guidance and processes for setting overall materiality

Movements in materiality and sample size guidance

In the last few years there has been downward pressure on audit fees through a combination of increased tendering and macro-economic conditions. As we have said in our recent annual reports on audit inspections, these market pressures pose risks to audit quality.

Whilst we noted recent improvements in the qualitative guidance provided by firms, we also identified a general trend for firms to make changes to their guidance to allow materiality to be set at a higher level, or to allow lower sample sizes to be used. As materiality levels should reflect the perceived financial information needs of users of the financial statements, this suggests that auditors believe users' needs and expectations have changed. These changes may result in a reduction in the amount of audit work performed.

Five of the six firms have changed their guidance in the past two years as follows:

- At firm A, the percentage guidance to be applied against benchmarks for non-public interest entities was increased, with the maximum percentage for one benchmark having more than tripled. This increase was part of an initiative which appeared to be primarily focused on generating efficiencies rather than improving audit quality.

- At firm B, the default percentages to be used where materiality was calculated using revenue or total assets benchmarks were doubled and the default performance materiality was also increased. Further, the guidance was changed to emphasise that the starting point should be the highest end of the ranges specified. The firm also more than doubled the default "clearly trivial" percentage.

- At firm C, the percentage range to be considered when using any gross benchmark (for example, revenue or total assets) was increased.

- At firm D, the previous minimum sample size for statistical samples was dropped to allow lower sample sizes. Further, the default 'clearly trivial' percentage was doubled.

- At firm E, the changes in percentage ranges were more balanced, resulting in lower materiality levels in some areas and higher materiality in others. However, the lowest percentage for setting performance materiality for public interest entities was increased.

Audit Committees should seek to 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.

Other changes in guidance

The extent and quality of sector-specific guidance varied between firms. However, there was sector-specific guidance at a number of the firms covering industries where the judgments required may be more complex (for example, pension funds, mutual funds, insurance companies, banks and building societies, mining companies and real estate/property companies).

In response to issues identified in previous AQR inspections, more detailed qualitative guidance around the setting of component materiality and the reporting of unadjusted misstatements to Audit Committees has been issued at a number of firms.

2.3 Performance materiality

ISA (UK&I) 320 states that planning the audit solely to detect individually material misstatements overlooks 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.

Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure.

The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; 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.

(ISA (UK&I) 320, paragraph A12)

Application of firms' guidance

Whilst the setting of performance materiality should be judgmental and not mechanical, every firm has issued internal guidance for setting performance materiality to operationalise the requirements of the Standard as follows:

	Firm 1	Firm 2	Firm 3	Firm 4	Firm 5	Firm 6
Percentage of materiality	50 to 75%	75 to 60% (default set at 75%)	50 to 75%	75% max	50 to 75%	90% max
Percentage of audits reviewed using the highest percentage allowed	100%	Over 50%	100%	100%	Under 25%	Between 25 and 50%

As shown above, one firm's guidance allows a higher performance materiality level than at other firms. This firm's guidance requires a judgmental approach to setting performance materiality, with a particular emphasis on the consideration of historic errors. We understand that the firm is considering lowering the maximum allowable performance materiality in 2014.

At four firms, all or the majority of audits defaulted to the highest permissible performance materiality under the firm's internal guidance. This was consistent with a general lack of explanations for the performance materiality set and no evidence that any judgment had been exercised. Auditors should ensure that the consideration of risk is a key factor in setting performance materiality.

In one audit, performance materiality was increased from 50% to 75%, in part to offset the impact of a fall in the overall materiality level and because the firm's guidance allowed the higher percentage to be used.

In another audit a higher performance materiality was justified on the basis that historical misstatements were low. However, the level of uncorrected misstatements identified in the current year's audit was significantly higher than expected and there was no reconsideration of the appropriateness of performance materiality by the audit team, as required by the firm's methodology, in view of this.

2.4 Setting materiality for account balances, classes of transactions and disclosures

> ISA (UK&I) 320 states that the auditor shall determine the materiality level or levels to be applied to particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users of the financial statements.
>
> (ISA (UK&I) 320 paragraph 10)

While audit firms' guidance and methodologies encourage audit teams to consider setting lower materiality levels for particular account balances, classes of transactions or disclosures, we did not identify any instances where this had been done in practice. Firms require more detailed work to be performed for sensitive areas such as directors' remuneration and related party transactions irrespective of the overall materiality level set.

One firm's guidance allows materiality for particular account balances, classes of transactions and disclosures to be set higher than overall materiality if the risk of misstatement is assessed as remote, which we believe to be inconsistent with ISA (UK&I) 320. On the one audit where this guidance appeared to have been applied, it had been misinterpreted as justifying a lower level of testing relating to revenue. We drew this matter to the firm's attention to enable it to take appropriate action.

2.5 Impact of materiality on audit testing

The impact of materiality on the audit work planned and performed varied depending on the individual audit strategies for testing account balances and classes of transactions.

On all but one of the audits that we reviewed, however, materiality affected, to a greater or lesser extent, the amount of audit work performed.

The setting of variances that can be accepted without further investigation during analytical procedures requires judgment and a number of factors such as risk and the level of disaggregation of balances affects the planned analytical procedures. However, these judgments were not explained in many cases and there appeared to be an underlying inconsistency in how materiality is applied in this area.

For example, in one audit where the key substantive test performed over revenue was analytical procedures, the variance set that could be accepted without further investigation was double the level of performance materiality, which does not appear to be justifiable. We have raised this matter with the firm concerned to enable them to take appropriate action.

Setting separate overall materiality levels for the balance sheet and income statement is not consistent with Auditing Standards. We only identified one instance of this, where materiality for the income statement was based on a percentage of profit before tax, but the audit team set a higher materiality level for the balance sheet based on a percentage of net assets. This higher 'balance sheet' materiality was also incorrectly used in auditing revenue, an income statement item. We asked the firm to assess the impact of this error on their audit.

Audit Committees should seek to gain an understanding of how materiality levels affect the extent of audit work undertaken in significant areas.

2.6 Impact of materiality on group audits

ISA (UK&I) 600 states that the group engagement team shall determine:

- Materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.
- The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

(ISA (UK&I) 600, paragraph 21)

Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level.

(ISA (UK&I) 600, paragraph 22)

If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

(a) materiality for the component financial statements as a whole; and

(b) performance materiality at the component level

meet the requirements of this ISA (UK and Ireland). (ISA (UK&I) 600, paragraph 23)

On many audits, the judgments made in setting component materiality were clearly recorded. However, we identified issues on several audits, each of which has been raised with the relevant firm to ensure that they are appropriately addressed, as follows:

- In one audit component materiality was higher than group materiality. In a further three audits component materiality was capped at the lower of group materiality and local statutory materiality. Auditing Standards require component materiality to be lower than group materiality.
- In one audit the group instructions issued to component auditors stated that performance materiality was the level beneath which misstatements were 'inconsequential', which is inappropriate.
- In several of the audits reviewed, the group auditors were not taking responsibility for, or having appropriate involvement in, the judgments made in determining component materiality, contrary to Auditing Standards. Furthermore, in one audit the group auditors delegated the setting of all component materiality levels to another audit team in the firm's international network and there was no evidence that the group team had any knowledge of what materiality level had been applied at each component.
- In two audits there was no rationale for the setting of component materiality. In a further audit the stated rationale was that component performance materiality was set at a 'prudent' level, despite it being the highest level permitted under the firm's guidance.

One firm set a floor for component materiality based on a percentage of group materiality. This appeared to carry a risk that materiality may be set too high where there are multiple components and, furthermore, to take away the judgment that group audit teams should be applying.

Audit Committees should seek to understand how auditors are ensuring that materiality is being determined appropriately at group and component levels.

2.7 Revisions to materiality

ISA (UK&I) 320 states the auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

Further, if the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

(ISA (UK&I) 320 paragraphs 12 and 13)

We generally found that firms' guidance and working papers encouraged audit teams to consider whether materiality should be revised during the audit. In most of the audits we reviewed, the audit teams had concluded that this was not necessary as there had been no change in circumstances that would suggest a different materiality level was appropriate.

However, where materiality was based on a percentage of forecast results, auditors did not always appropriately consider revising materiality:

- In three audits the actual results were lower than the forecast results used to calculate materiality, but there was no evidence that the audit team had considered reassessing materiality. In one of these audits it was incorrectly reported to the Audit Committee that final results were higher than forecast and the difference was not significant enough to warrant a change in materiality.
- In two audits where the audit team identified that actual results were lower than the forecast initially used to calculate materiality, there was no reassessment of whether the audit work performed to the previous higher materiality level remained adequate.

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.

2.8 Impact of materiality on evaluation of unadjusted misstatements

Auditing Standards require that auditors' evaluation of unadjusted misstatements should consider whether misstatements are qualitatively or quantitatively material. The firms' guidance in this area was comprehensive and generally followed in audit teams' consideration of unadjusted misstatements, with the judgments made being explained.

2.9 Communications with the Audit Committee

> ISA (UK&I) 450 states that the auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.
> (ISA (UK&I) 450, paragraph 12)

We saw many examples of accurate and high quality reporting to Audit Committees. However, improvements are required in the areas set out below.

Reporting of uncorrected misstatements

One firm's "Consideration of misstatements" template required audit teams to identify individual items that should be adjusted for in order to bring the aggregate uncorrected misstatements below overall materiality. This guidance implies that the firm are willing to accept some misstatements not being corrected by management, rather than requesting that they all be corrected as required by Auditing Standards. Further, on two audits at this firm the audit team did not request the Audit Committee to adjust the financial statements for identified errors which it concluded were not material.

On a further twelve audits, the audit teams did not request that the Audit Committee adjust the financial statements for identified misstatements. In three of these audits the audit teams advised that the errors were not material, thereby implying adjustment was not required. Audit teams should request that all uncorrected misstatements be adjusted for.

Audit Committees should ensure they 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.

Audit Committees should also seek to 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.

Accuracy of reporting to Audit Committees

> ISA (UK&I) 260 requires that the auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit and states that this may assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures.
> (ISA (UK&I) 260 paragraphs 15 and A12)

At one firm the level at which materiality was set was not generally communicated to the Audit Committee. We were informed that this was to ensure that management were not aware of materiality levels so as to enable the firm to retain an appropriate level of unpredictability in the audit testing planned and performed. Appropriate reporting to Audit Committees, however, is not in our view inconsistent with this consideration as judgment can be exercised by audit teams in deciding the level of detail in which they should report. The firm confirmed that it would be changing this practice on implementing the revised standard on auditor reporting (ISA (UK&I) 700).

We identified the following instances of inaccurate reporting of materiality levels or reporting thresholds to Audit Committees:

- In one audit overall materiality, performance materiality and the reporting threshold notified to the Audit Committee were all lower than the amounts actually applied in practice. In a further audit the audit team reported that lower materiality levels would be set for higher risk areas, but we found no evidence of this being the case.

- In four audits the audit team recorded and collated errors at a higher level than the reporting threshold they had advised to the Audit Committee.

- In six audits the audit team did not report all errors identified above the reporting threshold. In a further two audits uncorrected misstatements included in a draft letter of representation had not previously been reported to the Audit Committee.

Audit Committees should seek confirmation from their auditors that any changes subsequently made to the materiality levels and reporting threshold initially advised have been reported to them.

2.10 "Clearly trivial" misstatements

ISA (UK&I) 450 requires that the auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.

(ISA (UK&I) 450 paragraph 5)

The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because they clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material". It is limited to matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about this, the matter is considered not to be clearly trivial.

(ISA (UK&I) 450 paragraph A2)

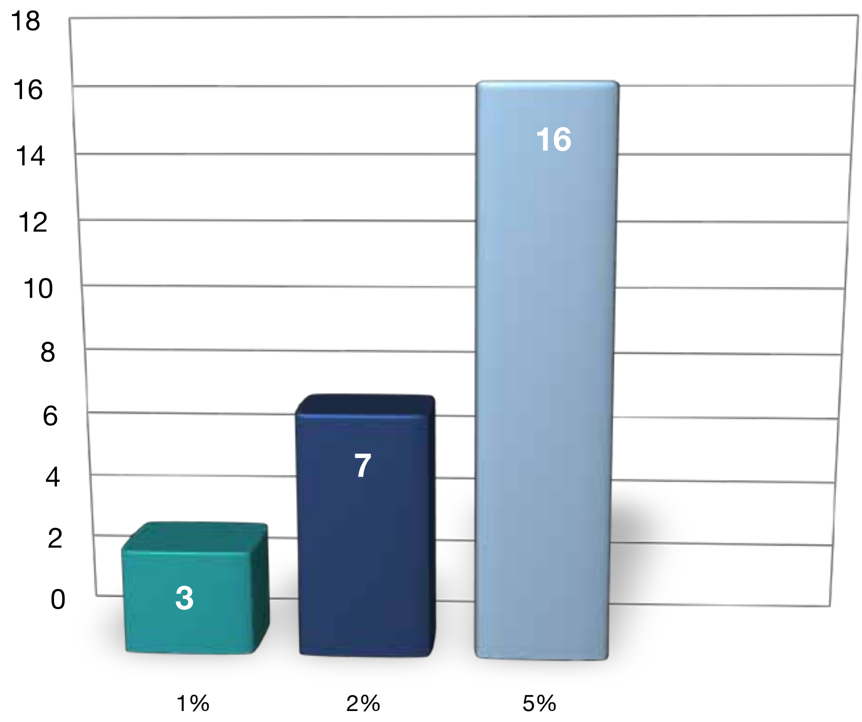
All the firms' guidance was prescriptive in specifying "clearly trivial" limits that should be used, limiting the judgment which can be exercised by audit teams. The maximum permitted clearly trivial limit at one firm was 10% of materiality, which is double the maximum level at the other firms.

A summary of the firms' guidance is set out below:

	Firm 1	Firm 2	Firm 3	Firm 4	Firm 5	Firm 6
Percentage of materiality	5% default, up to 10%	5%	Up to 5%, with 2% default	3% to 5%	5%	Up to 5%, with 2% default

We did not see many instances where the clearly trivial limit used was justified. In nearly all audits, it was either calculated at the level that the firm's template defaulted to or, alternatively, the maximum level permitted by the firm.

The clearly trivial limits used on the 26 audits we reviewed, as a percentage of materiality, were as follows:



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