Materiality – concepts and approaches

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Jan Tyl, CFRR Vienna, February 2013
Key issues when assessing internal control

Where are we in the audit process?

- Perform preliminary engagement activities
  - Purpose: Decide whether to accept engagement
  - Documentation: Listing of risk factors, independence
- Plan the audit
  - Purpose: Develop an overall audit strategy and audit plan
  - Documentation: Materiality, audit team discussions
- Perform risk assessment procedures
  - Purpose: Identify/assess RMM through understanding the entity
  - Documentation: Business & fraud risks including significant risks, design/implementation of relevant internal controls, assessed RMM at: F/S level, assertion level
Setting the scene*

Company law requires accounts to give a "true and fair view". Company law requires auditors to report on whether accounts give a "true and fair view". But what do these terms mean? They are not defined by legislation, or by the accounting profession. As a result, it is subject to considerable uncertainty and is therefore the most difficult and judgmental aspect of auditors' responsibilities.

* This presentation is based on “The Impact of Materiality: Accounting’s Best Kept Secret,” by Niamh Brennan (University College Dublin) and Sidney J. Gray (University of Sydney)
Setting the scene

» Auditors obtain sufficient appropriate audit evidence to provide *reasonable assurance* that financial statements *taken as a whole* are *free of material misstatement*

» The concept of materiality (in effect) builds flexibility into financial reporting. This can lead to abuse. Companies may intentionally record "small" errors within a defined percentage ceiling, so that auditors will not scrutinize such errors (as they are not material).

« “The remainder of the earnings reductions of $92 million from 1997 through 2000 came from what Enron called "prior year proposed audit adjustments and reclassifications"… recommended by Arthur Andersen, Enron's auditors, but not made because the auditors were persuaded the amounts were immaterial.”
Definitions of Materiality

» Legal Definitions of Materiality
  – The relevance of materiality in law relates to whether court findings should be influenced by the materiality of the crime. Statutes must specify that materiality be taken into account for it to be considered relevant to court findings. For example, in U.S., materiality is an element in false statement and fraud statutes and there is a number of definitions of materiality.

» Professional Accounting Definitions of Materiality
  – In financial reporting, definitions of materiality are important to three groups of stakeholders: preparers of financial statements, auditors, and users of financial statements. Although materiality decisions are made by only two of these three groups, preparers and auditors, the auditing profession's definitions of materiality have a user-orientation.
Definitions of Materiality

These definitions raise a number of questions:

- How do preparers or auditors know what would reasonably influence decisions of users?
- Are preparers' or auditors' understandings of what would reasonably influence the users the same or consistent with those of users of financial statements?
- Are preparers' or auditors'/users' understandings of what would reasonably influence the users the same or consistent from preparer to preparer; auditor to auditor; user to user?
Definitions of Materiality

“It is becoming more and more common for the judicial system to make decisions on accounting matters that are in conflict with what has been accepted within the accounting profession. Unfortunately the accountant has a great deal to lose if the judicial system disagrees with his decision on what was and was not material.” (K.R. Jeffries)

"We have to deal with words, there is nothing more fluid than words“ (Judge Learned Hand)
Methods of assessing whether an item is material

» Current Period/Income Statement/Rollover Method of Assessing Materiality
  – The income statement method of assessing materiality is also called the current period or rollover method (as effects of prior period errors are rolled over to offset current period methods). In deciding whether an amount is material, the total amount during a period is compared to net income for the period.

» Cumulative/Balance Sheet/Iron Curtain Method
  – The balance sheet method of assessing materiality is also called the cumulative or iron curtain method. In deciding whether an amount is material, the total cumulative amount at the end of a period is compared to net income.
Methods of assessing whether an item is material

» Current Period/Income Statement/Rollover Method
  - The income statement method of assessing materiality is sometimes called the current period or rollover method (as effects of prior period errors are rolled over to offset current period errors). In deciding whether an amount is material, the total amount during a period is compared to net income for the period. This method considers as an error amounts that have been recorded in the current period statements that should not have been.

» Cumulative/Balance Sheet/Iron Curtain Method
  - The balance sheet method of assessing materiality is sometimes called the cumulative or iron curtain method. In deciding whether an amount is material, the total cumulative amount at the end of a period is compared to net income. This method considers as the error the total amount which should have been recorded in both the current period and prior periods.
Methods of assessing whether an item is material

Example: Cookie jar reserves
- A company overstates expenses which has the effect of understating income by $10 million per annum in years 1, 2 and 3. You are to assume that only amounts of $30 million or more are material. In year 4 the company reverses the error which increases the income by $30 million.

Question
- 1. What is the amount of the error in each year under the:
  - Current period/income statement method of assessing materiality?
  - Cumulative/balance sheet method of assessing materiality?
- 2. In your assessment, is this error material?
## Methods of assessing whether an item is material

**Example: Cookie jar reserves solution**

<table>
<thead>
<tr>
<th></th>
<th>i. C-P/ IS $m</th>
<th>ii. C/B/S $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect on reserves – Year 1</td>
<td>Not material (10)</td>
<td>Not material (10)</td>
</tr>
<tr>
<td>Effect on reserves – Year 2</td>
<td>Not material (10)</td>
<td>Not material (20)</td>
</tr>
<tr>
<td>Effect on reserves – Year 3</td>
<td>Not material (10)</td>
<td>Material (30)</td>
</tr>
<tr>
<td>Reversal of effect – Year 4</td>
<td>Material 30</td>
<td>Not material 0</td>
</tr>
</tbody>
</table>

### Materiality – concepts and approaches
Methods of assessing whether an item is material

Example: Cutoff error

A company records sales in the wrong accounting period (cutoff error). Sales in Year 1 includes $10 million of Year 2 sales. Year 2 sales includes $12 million of Year 3 sales.

Questions

1. What is the amount of the error in Year 2 under the:
   - Current period/income statement method of assessing materiality?
   - Cumulative/balance sheet method of assessing materiality?

2. In your assessment, is this error material?
Materiality – concepts and approaches

Methods of assessing whether an item is material

Example: Cutoff error solution

i. Current-period/income statement method

- Effect on Year 2 sales revenue/income

\[
[\$(10) \text{Year 2 sales included in Year 1 in error} + \$12 \text{Year 3 sales included in Year 2 in error}] = 2 \text{ million}
\]

ii. Cumulative/balance sheet method

- Effect on sales revenue/income (only includes the error in Year 3 as the error in Year 1 has reversed by the end of Year 2) 12 million; Effect on debtors/accounts receivable (end of Year 2 error only) = 12 million
Methods of assessing whether an item is material

Materiality in the case of Enron - case details

Enron had to correct accounts back to 1997, resulting in total reduction of Enron's audited profits by $591 million

Correction for 1997, $51 million

Reported profits in 1997, $105 million

Adjustment resulted in reduction of reported profits by almost 50% to $54 million (from $105 million)

Question

Were the unadjusted audit items of $51 million in 1997 material?
Methods of assessing whether an item is material

Solution

The restatements included prior-period proposed audit adjustments and reclassifications, which were determined to be *immaterial* in the periods originally proposed.

Auditor decisions on materiality

Primarily quantitative methods used to calculate materiality

Rules of thumb used to quantify the threshold cutoff
Methods of assessing whether an item is material

» *Common rules of thumb*

- 5-10% pre-tax income: < 5% *normal* profit before tax immaterial; >10% profit before tax material; 5-10% – auditor to apply judgment

» 1/1.5% of larger of: Total assets or Revenue

» *Justification for immateriality decision in Enron's case*
  - In 1997 Enron had taken large nonrecurring charges
  - Given the large nonrecurring charges, should materiality be based on reported income of $105 million or on adjusted earnings before items that affect comparability – what accountants call normalized earnings?

» "*We looked at the total mix*" J F Berardino, CEO Arthur Andersen
Research on materiality

» Size/Materiality Thresholds
  – 1989 paper summarized prior empirical findings on materiality thresholds. Thresholds ranged from as high as 41 percent, with items of 4 to 5 percent being immaterial. The paper also identified the method of measurement to assess materiality applied in prior research. The most common measure is net income, but book value of total assets/net worth, earnings growth, and leverage have also been used.

» Auditor Judgments
  – Auditors (and their materiality judgments) are the most common user group studied by researchers.
Materiality – concepts and approaches

Research on materiality

- the effect of an adjustment on income is the primary determinant of auditors' decisions to qualify the audit opinion
- income is the primary factor considered by auditors in arriving at decisions around what is material
- Big 5 auditors to make more conservative materiality calculations than non-Big 5 auditors
- auditors require clients to record adjustments where the approach to materiality applied shows the error to be most material
- lack of consensus amongst auditors in defining materiality
Research on materiality

- the effect of an adjustment on income is the primary determinant of auditors' decisions to qualify the audit opinion
- income is the primary factor considered by auditors in arriving at decisions around what is material
- Big 5 auditors to make more conservative materiality calculations than non-Big 5 auditors
- auditors require clients to record adjustments where the approach to materiality applied shows the error to be most material
- lack of consensus amongst auditors in defining materiality
- auditor and investor judgments to be similar
Materiality – concepts and approaches

Materiality disclosure – would it lead to better understanding of financial statements?

» Preparers

» Auditors
THANK YOU