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Audit Committee Briefing Note - Materiality

Audit Review: **BRIEFING NOTE 5**

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[1]Audit Quality Thematic Review – Materiality - December 2013

http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/December/FRC-issues-report-on-auditor-s-materiality-judgeme.aspx

Audit Review has long called for greater transparency of information about how materiality levels are set and revised by external auditors. We believe that by doing so users of the accounts will better understand the level of comfort that an audit brings. The Financial Reporting Council (FRC) has just published its first 'Thematic Review'[1] which builds on recent changes to the audit report. The Review has been sent to FTSE350 Audit Committee Chairs with encouragement to consider the content of the report. This paper is intended to provide an overview briefing for Audit Committees.

The 6 Key FRC findings

1. Five of the 6 firms who audit the FTSE350 have changed their materiality guidance which would either lead to higher materiality levels or the impact of materiality assessments being reduced.

2. Some firms (though the firms are not identified) have higher permitted acceptable materiality ranges than others. The FRC notes that: "this may result in less audit work being performed ... than at other firms" for companies with a similar size and risk profile.

3. All 6 firms have templates for setting overall materiality and "clearly trivial" limits, though individual auditors did not always explain and justify their judgements in completing the templates.

4. In the majority of cases, materiality levels were the maximum permitted by the firm's guidance. In a cutting comment, the FRC notes: "such an approach is not consistent with appropriate exercise of individual judgement as required."

5. Auditors did not always appropriately consider revising materiality based on forecasts when performance was significantly worse than forecast.

6. There were instances noted where auditors had not reported all errors above the reporting threshold and cases where errors were recorded at a higher level than the reporting threshold advised to the Audit Committee. In one instance there was no reporting of materiality levels to the Audit Committee.

Key auditor actions

The FRC called for auditors to "review their internal guidance in the light of the areas requiring improvement identified in the report, including in particular how the needs and expectations of users of financial statements are assessed and taken into account in determining materiality levels."

Key audit committee actions

The FRC notes: "audit committees play a highly important role in safeguarding the quality of audit and should actively engage with their auditors in relation to the determination and application of materiality."

The FRC has summarised the matters which audit committees should focus on and which may enhance their oversight of the audit process. Audit committees should seek to fully understand:

- the basis for the materiality levels set
- how materiality levels are expected to affect the level of audit work
- the benchmarks used by their auditors in determining materiality
- the reasons for and the effect of any increase in materiality levels and the likely impact on the level of audit work (including whether the auditors believe that the needs and expectations of users of the financial statements have changed)
- how materiality levels affect the extent of audit work in significant areas
- how the auditors determine materiality at group and component levels
- whether materiality levels should have been adjusted in the light of significant events arising near the year end and/or actual results are worse than forecast
- why any misstatements have not been corrected by management. The committee should "instruct management to make the relevant adjustments where appropriate"
- whether disclosure and omissions reported by the auditors have arisen through error or a specific management judgement and whether the inclusion of such disclosures is likely to provide material information to users.

In addition, audit committees should obtain confirmation from their auditors that changes made to the materiality levels and misstatement reporting threshold have been reported to them.

Audit Review comment

Materiality is a very sensitive area for investors and other users of accounts because it has a huge impact on the scope and extent of audit work performed.

The FRC's timing is crucial as auditors now have to disclose (for listed companies) how they applied the concept of materiality in their audit reports. With the first sets of new-style audit reports beginning to appear, we believe this may cause a few surprises and stimulate greater debate.

Perhaps the two most hard hitting comments by the FRC revolve around communication issues. There is a call for auditors to "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." The implication here is that there may have been a temptation to push performance materiality to the maximum allowed under a firms guidance without fully demonstrating the consideration of risk. The FRC further comments on an area that Audit Review have highlighted in the past: that 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."

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