Agenda Item 3

Materiality in Review Engagements

Objective of Agenda Item

To consider issues with respect to materiality in review engagements and whether additional requirements or guidance is needed. Such guidance could be developed at a standards level or as part of the Guide.

How an Accountant Uses Materiality in a Review Engagement

Statements on Standards for Accounting and Review Services (SSARSs) have historically addressed the concept of materiality in the context of the preparation and presentation of financial statements. Exhibit A to this discussion memorandum illustrates the applicable paragraphs from AR-C section 90, *Review Engagements*.

In order to determine (in accordance with paragraph .28 of AR-C section 90), whether material modification should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework, the accountant would have to determine materiality. In practice many accountants make a determination of materiality as part of determining the appropriate review procedures to be performed and again as part of evaluating the review evidence obtained in determining whether the financial statements are materially misstated. Many accountants document their materiality determination as part of a planning document. The applicable sections from Practitioners Publishing Company's Guide to Compilation and Review Engagements is presented as Exhibit B to this discussion memorandum.

International Standard on Review Engagements 2400 (Revised), *Engagements to Review Historical Financial Statements* (ISRE 2400 (Revised))

ISRE 2400 (Revised) is available at:

https://www.ifac.org/system/files/publications/files/International-Standard-on-Review-Engagements-2400-(Revised)-Engagements-to-Review-Historical-Financial-Statements.pdf

While ISRE 2400 (Revised) does not require the accountant to calculate performance materiality, the following requirements are included:

> 43. The practitioner shall determine materiality for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures. (Ref: Para. A70–A73)

44. The practitioner shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the review that would have caused the practitioner to have determined a different amount initially. (Ref. Para. A74)

Paragraphs A70 – A74 of ISRE 2400 (Revised) are consistent with paragraphs A4 – A8 of AR-C section 90 which are included in exhibit A to this discussion memorandum.

To assist practitioners in applying ISRE 2400 (Revised), the International Federation of Accountants (IFAC) Small and Medium Practices (SMP) Committee prepared a Guide to Review Engagements. That Guide is available at http://www.ire.lu/fileadmin/media/Env_normatif_international_non_ISA/201312_IFAC-SMP-Guide-to-Review-Engagements_0.pdf. The pages relevant to the determination and application of materiality in a review engagement are presented as agenda item 3A.

AU-C section 930, *Interim Financial Information*

While AU-C section 930 does not specifically require the auditor to calculate materiality as part of a review of interim financial information, paragraph .A11 of that section states that "The auditor's understanding of the entity and its environment, including its internal control, the results of the risk assessments relating to the preceding audit, and the auditor's consideration of materiality as it relates to the interim financial information, influences the nature and extent of the inquiries made and analytical procedures performed."

How an Accountant Considers Risk in a Review Engagement

The concept of materiality in a review engagement is tied to the accountant's awareness of the risk that the accountant may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated. In accordance with paragraph .17 of AR-C section 90 the accountant bases the design and performance of review procedures on such risk awareness (in addition to his or her understanding of the industry and knowledge of the entity). Paragraph .18 of AR-C section 90 requires that the accountant focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of material misstatements. The accountant's risk awareness is fluid as the results of the accountant's analytical procedures and inquiries may modify the accountant's risk awareness (paragraph .A31 of AR-C section 90).

It is important to remember that a review does not contemplate obtaining an understanding of the entity's internal control.

(ISRE 2400 (Revised))

ISRE 2400 (Revised) links the concept of risk in a review engagement (referred to as *engagement risk*) to the concept of *limited assurance*. Limited assurance is defined as the level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion. The combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the financial statements.

ISRE 2400 (Revised) further states that it is necessary for the practitioner to maintain *professional skepticism* throughout the review in order to reduce risk (paragraph A19 of ISRE 2400 (Revised) and that *professional judgment* is necessary when evaluating whether the evidence obtained from the procedures performed reduces the engagement risk to a level that is acceptable in the engagement circumstances (paragraph A21 of ISRE 2400 (Revised)).

<u>AU-C section 930</u>

While procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information, the auditor's understanding of the entity and its environment, including its internal control, the results of the risk assessments relating to the preceding audit, and the auditor's consideration of materiality as it relates to the interim financial information, influences the nature and extent of the inquiries made and analytical procedures performed (paragraph .A11 of AU-C section 930).

Action Requested of ARSC
The ARSC is asked to consider whether additional requirements or guidance is needed with respect to materiality in review engagements. If such requirements/guidance is determined to be necessary, the ARSC is further asked to consider whether a project to develop such requirements/guidance should be initiated as a joint project with the Auditing Standards Board (as the issues would also be relevant to interim reviews performed in accordance with AU-C section 930.

Agenda Items Presented:

Agenda item 3A	Pages relevant to the determination and application of materiality in a review engagement from the IFAC SMP Committee's Guide to Review Engagements.

Exhibit A – AR-C section 90 – Consideration of Materiality in a Review Engagement

Introduction, Definitions, and Requirements	Application and Other Explanatory Material
Objective	**Objective** (Ref: par. .04 and .28)
.04 The objective of the accountant when performing a review of financial statements is to obtain limited assurance as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, primarily through the performance of inquiry and analytical procedures. (Ref: par. .A3–.A8)	***Materiality*** **.A4** The accountant's consideration of materiality is made in the context of the applicable financial reporting framework. Some financial reporting frameworks discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that • misstatements, including omissions, are considered to be material if they, individually or in the aggregate, 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 light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and • judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Introduction, Definitions, and Requirements	Application and Other Explanatory Material
	.A5 If present in the applicable financial reporting framework, a discussion of the concept of materiality provides a frame of reference to the accountant in determining, as required by paragraph .28, whether there are any material modifications that should be made to the financial statements in order for the statements to be in accordance with the applicable financial reporting framework. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph .A4 provide the accountant with such a frame of reference. **.A6** The accountant's determination of materiality is a matter of professional judgment and is affected by the accountant's perception of the needs of the intended users of the financial statements. In this context, it is reasonable for the accountant to assume that users • have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence; • understand that financial statements are prepared, presented, and reviewed to levels of materiality; • recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and • make reasonable economic decisions on the basis of the information in the financial statements.

Introduction, Definitions, and Requirements	Application and Other Explanatory Material
	Further, unless the review engagement is undertaken for financial statements that are intended to meet the particular needs of specific users, the possible effect of misstatements on specific users, whose information needs may vary widely, is not ordinarily considered. **.A7** The accountant's judgment about what is material in relation to the financial statements as a whole is the same regardless of the level of assurance obtained by the accountant as a basis for expressing a conclusion on the financial statements. ***Revising Materiality*** **.A8** The accountant's determination of materiality for the financial statements as a whole may need to be revised during the engagement as a result of • a change in the circumstances that occurred during the review (for example, a decision to dispose of a major part of the entity's business). • new information, or a change in the accountant's understanding of the entity and its environment as a result of performing review procedures (for example, if during the review it appears actual financial results are likely to be substantially different from anticipated period-end financial results that were used initially to consider materiality for the financial statements as a whole).

Exhibit B – Applicable sections from Practitioners Publishing Company's Guide to Compilation and Review Engagements is presented as Exhibit B to this discussion memorandum.

DOCUMENTING MATERIALITY

407.1 SSARS do not require practitioners to document materiality. Consequently, the authors recommend materiality NOT BE DOCUMENTED in a review or compilation since it is not required by SSARS. From a practical standpoint, most practitioners use professional judgment when considering materiality in a review engagement. See the materiality discussions in section 522 and section 608.

407.2 However, some practitioners and firms may choose to document materiality even though it is not required. In these instances, the authors caution practitioners against using the "Financial Statement Materiality Worksheet for Planning Purposes," illustrated at ASB-CX-2.1 of *PPC's Guide to Audits of Nonpublic Companies*, because that form is designed for an audit. If materiality is documented, the authors recommend practitioners rely primarily on professional judgment rather than mathematical calculations.

408 ACCUMULATING PASSED ADJUSTMENTS

408.1 SSARS No. 21 (AR-C 90.27–.28) requires the accountant to accumulate and evaluate, individually and in the aggregate, misstatements, including inadequate disclosure, to determine whether material modifications need to be made to the financial statements for them to be in accordance with the applicable financial reporting framework. When evaluating materiality, consideration should be given to—

- The nature, cause, and amount of the misstatements.
- Whether the misstatements existed in the prior year.
- Whether it is appropriate to offset an estimated misstatement with a precise misstatement.
- The potential effect of the misstatements on future periods.
- Whether the accumulation of immaterial misstatements could become material in future periods.

408.2 In most small business review engagements, the client records the majority (if not all) of the adjusting entries proposed by the accountants. Significant differences in expectations and recorded amounts when applying analytical procedures are generally followed up with additional procedures and/or inquiries to explain the difference, or additional procedures are performed to isolate the potential misstatement. For that reason, it is usually unnecessary in a review engagement for accountants to accumulate passed adjustments to determine their impact on the financial statements. Consequently, practitioners seldom prepare a summary of differences worksheet or similar document.

408.3 Although the authors believe that it is both conservative and prudent to encourage the client to book all misstatements or adjustments in a review engagement, in the event passed adjustments do exist, SSARS No. 21 (AR-C 90.34i) requires that a summary of such adjustments be included in, or attached to, the management representation letter.

408.4 In evaluating the materiality of adjustments, the practitioner should not use the estimate of planning materiality, which is used to determine the nature, timing, and extent of review procedures to be applied, to determine whether an adjustment (individually or combined with other adjustments) is material. Evaluation materiality is different from planning materiality. (See materiality discussion in section 522.)

408.5 In evaluating adjustments, the practitioner should consider the adjustments in relation to individual accounts (e.g., accounts receivable) and subtotals (e.g., current income), not to their relationship to planning materiality. The practitioner should also evaluate the passed adjustments from a qualitative perspective. For example, a small adjustment may be particularly sensitive to the users of the financial statements and, therefore, material. Of course, evaluation materiality, which consists of quantitative and qualitative assessments, has to be viewed from the perspectives of the financial statement users and whether the amount or disclosure would be important to the decisions that users would be making.

408.6 In summary, the authors recommend that—

a. All adjustments should be booked by the client. If significant differences in expectations and recorded amounts are noted when applying analytical procedures, such differences should be followed up with additional procedures and/or inquiries to explain the difference, or additional procedures should be performed to isolate the potential misstatement.
b. If all adjustments are not booked, the practitioner should evaluate the adjustments that are not booked by assessing their materiality (individually and in combination) in relation to individual accounts, subtotals, and totals in the financial statements.
c. Do not use planning materiality for the evaluation in item b. above.
d. Finally, also evaluate the adjustments from a qualitative materiality perspective.

522 MATERIALITY

522.1 Various financial reporting frameworks include a discussion of materiality in the context of the submission of financial statements.[38] Those frameworks generally discuss materiality as follows:

- Misstatements, including omissions, are considered to be *material* in circumstances when they, individually or in the aggregate, could reasonably be expected to influence the decisions of the users of the financial statements.
- The size or nature of a misstatement (or a combination of both) in light of surrounding circumstances affect judgments about *materiality*.
- The common financial information needs of users *as a group* are considered when making *materiality* judgments. What may be considered *material* to a *specific* individual user is not considered.

522.2 The accountant has a responsibility to consider materiality in all SSARS engagements. This is evidenced throughout the SSARS:

- In a financial statement preparation engagement—
    - AR-C 70.18 indicates the accountant should disclose *material* departures from the applicable financial reporting framework.
- In a compilation engagement—
    - AR-C 80.13 indicates the accountant should read the financial statements and consider whether they are appropriate in form and free from obvious *material* misstatements.
    - AR-C 80.27 indicates the accountant should disclose *material* departures from the applicable financial reporting framework.
- In a review engagement—
    - AR-C 90.15 indicates the accountant should obtain an understanding of the entity's business and accounting principles used in order to identify areas where there is a greater chance that *material* misstatements may exist.
    - AR-C 90.17 indicates the accountant should design his or her review procedures to obtain limited assurance as a basis for reporting whether the accountant is aware of any *material* modifications that should be made to the financial statements.

- AR-C 90.19 discusses applying analytical procedures to identify relationships and items that are unusual and may indicate a *material* misstatement.
- AR-C 90.22f indicates the accountant should inquire of management concerning subsequent events that could have a *material* effect on the financial statements.
- Both AR-C 90.28 and AR-C 90.30 address evaluating the *materiality* of the evidence obtained.
- AR-C90.34i requires the accountant to get a written representation from management that they believe that the effects of uncorrected misstatements are *immaterial*.
- The review report even addresses *materiality* when it states:

> Based on my (our) review, I am (we are) not aware of any *material* modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America. [Emphasis added]

522.3 In compilations and reviews, the accountant's determination of materiality is a matter of professional judgment. When making this judgment, the accountant may consider the needs of the users of the financial statements. It is reasonable for the accountant to assume that these users—

- Have a reasonable knowledge of business, economic activities, and accounting.
- Have a willingness to study the information in the financial statements with a reasonable amount of diligence.
- Understand that materiality judgments are made when preparing, presenting, and reviewing the financial statements.
- Recognize that there are inherent uncertainties associated with the amounts included in the statements that involve estimates, judgment, or the consideration of future events.
- Make reasonable decisions on the basis of information in the financial statements.

What Is a *Material* GAAP Departure?

608.5 *Materiality* is a term used to describe the significance of a departure from generally accepted accounting principles. Only material departures require correction.

608.6 Determining what is material to the financial statements taken as a whole is one of the most difficult decisions in the accounting profession. Statement of Financial Accounting Concepts (SFAC) No. 8, *Conceptual Framework for Financial Reporting—Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information,"* states the following regarding materiality:[9]

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the [FASB] cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

608.7 Section 407 includes a discussion on documenting materiality; and section 522 includes a discussion of materiality as it relates to the SSARS. Some might argue that the guidance is nebulous, but a more definite statement is probably impossible since materiality is a matter of judgment in the circumstances.